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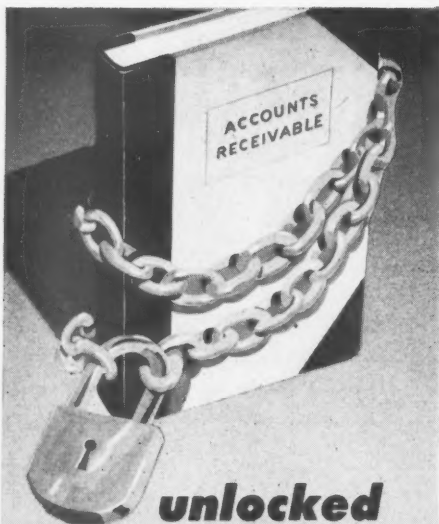
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BOOK REVIEWS

Distribution Costs (Second Edition)

By J. Brooks Heckert and Robert B. Miner. THE RONALD PRESS COMPANY, New York, N. Y., 1953. Pages: ix + 386; \$6.50.

Here is an up-to-date revision of a valuable book in a field in which not too much has been written. As is well known, distribution costs, or rather the absence of them, were first brought to public attention during the hearings on the Robinson-Patman Act when the accounting officers of national concerns revealed that they had no reliable data on their marketing costs. Since that time this area of cost determination has been the object of considerable investigation, and this latest book by Professors Heckert and Miner of Ohio State University gives an admirable presentation of current practice in this field.

The book consists of two parts—the analysis of distribution costs, and the control and planning of distribution costs. The first part contains some twelve chapters and in the preface the authors state that in this part the "different bases of allocation are suggested under varying circumstances, and there is a thorough treatment of the net profit and contribution margin approaches to distribution costs analysis." The second part examines the procedures for controlling costs and summarizes significant legislation in the marketing field.

When one considers that the cost of distributing goods accounts for between 50 and 60 per cent of the consumer's dollar, the importance of obtaining exact information about distribution costs is immediately apparent; but the techniques for gathering and applying this type of cost have not received the same attention as have manufacturing costs, perhaps because of the old economists' belief that only productive costs are worthy of examination. Nevertheless, the functions involved in distribution are as necessary as any other functions required to place goods in the hands of the ultimate consumer, and the field deserves the attention of our best accounting minds. It is a pleasure, therefore, to report that the problem has been squarely faced and intelligently presented in the book under review.

Obviously, the basic purpose of distribution cost analysis is to supply marketing management with data needed to direct distribution effort. Where and how to sell, and at what price, are problems that a business must solve successfully or cease to exist. The problem is well stated by the authors in their chapter on the "Problems of Distribution Cost Analysis."

Distribution costs are analyzed for the purpose of cost determination, cost control, and direction of effort. While it is not the practice to absorb distribution costs in inventory values, the costs must be determined for purposes of establishing distribu-

(continued on page 302)

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Book Reviews

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tion policies; setting prices; and preparing
divisional operating statements, such as
those for territories, commodities, and
branches. As in the case of production,
the most important purpose of distribution
cost analysis is the control of costs and
the intelligent direction of effort.

Instead of the usual analyses of operations
and product which are traditional in manu-
facturing costs, distribution costs require
many analyses and cross-analyses to be of
real help in marketing guidance. Each of the
usual bases of analysis used in distribution
costs are considered in detail and the book
presents chapters on analyses by territories,
commodities, channels of distribution and
methods of selling, customers, size of orders,
and organization and operating divisions.
Such special analyses for particular purposes
as those by salesmen, method of delivery, and
terms of sale are also considered.

The second part of the book will probably
be of more interest to marketing management
because of its emphasis on control. In this
section the authors first discuss how to de-
velop distribution standards that can be ap-
plied to both costs and results which, of
course, differs from the usual production
standards of cost and quality. Although it
is admittedly difficult to establish standards
for some distribution activities, because of
the greater relative importance of psycho-
logical rather than mechanical or physical
factors, and the greater dependence of dis-
tribution costs on executive judgment, these
factors exist only in certain areas of distribu-
tion and are of little importance in others.
Much of distribution activity can be mea-
sured as adequately as production, and stan-
dards for order handling, warehousing, ship-
ping, delivery, and clerical work can be
subjected to the same scientific development
as in production work. Even the areas of ad-
vertising and personal selling can be subjected
to reasonably accurate measurement when
the activities are continuous or repetitive.

Following the general statement on the
needs for standards and methods of develop-
ing them, the authors apply these principles
to different types of distribution costs. There
are chapters which discuss the controlling
of such expenses as selling, physical distribu-
tion, credit and collection, and financial and
general distribution. In each of these chap-
ters the number of specific examples make
the material most helpful. The valuable in-
formation on the preparation and operation
of a distribution cost budget is presented and
anyone who has been faced with the task of
preparing such a budget can appreciate the
several suggestions the authors make herein.
Not the least valuable of the material con-
tained in this book is the summary of the
most important current government regula-

(Continued on page 303)

Book Reviews

(Continued from page 302)

tions in the marketing field with analyses of the specific acts. This material is supplemented by a bibliography to aid those wishing detailed information about a particular law.

This book will be a valuable addition to the library of any businessman who is concerned with the problems of distribution. It can be used as a text for certain advanced courses where the lack of discussion questions and problem material would not inhibit its successful use.

The authors are to be congratulated for the second edition of a work which continues to be an outstanding one in its field.

CHARLES L. SAVAGE

Adelphi College
Garden City, New York

Auditing

By William H. Bell and Ralph S. Johns.
PRENTICE-HALL, INC., New York, N. Y.,
1952. Pages: x + 564; \$8.00.

This 1952 revised edition of a standard auditing text, previously revised in 1941, contains several new features although the basic text, treatment and aims have been retained. The new features consist of a new chapter on working papers, an appendix containing an internal control questionnaire, and a collection of cases and problems suitable for classroom use.

In the Preface the authors restate as their aim the preparation of a "thoroughly practical treatise on auditing." Although auditing is essentially a practical function it may be questioned whether practice can be successful, or a proper understanding of its basis achieved, without theoretical guide. The period since the last edition has been marked by dynamic change and deepened understanding of the objectives of auditing. Considerable authoritative literature, including case studies, have been published during this period by the AIA, the SEC and state CPA societies on the subject of auditing standards, principles, and ethical practice. The final chapter of this book on The Report reflects an awareness of this current in its brief reference to the AIA's Tentative Statement Of Auditing Standards and the reproduction of the several auditing standards originally presented in the latter document. This newer viewpoint, however, which would embrace an approach to auditing practice within the disciplined limits of an enlightened application of soundly established standards and principles, has been passed over by the authors in favor of the traditional presentation of "practical" procedures and observations. The book, therefore, necessarily manifests discreteness in the development of the subject but, at the same time, it is replete with satisfying practical observations and advice.

(Continued on page 305)

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Book Reviews

(Continued from page 303)

ments which will be appreciated by the practitioner and welcomed by the student.

The first two chapters are introductory and review briefly such topics as the purposes of auditing, classes of audits, and preliminary arrangements with the client. Chapter three is concerned with general procedure and includes a discussion on method of beginning an audit, the audit program and order of audit procedure. Chapters four to six are devoted to procedures relating to the examination of the books of original entry. Included therein are comments on vouchers, footings, verification of postings, detailed procedures for cash examination, and internal control. The procedures related to individual accounts are thereafter presented in the traditional form following the balance sheet order and are covered in chapters seven to fifteen. A single chapter is allotted to the operating accounts. The authors have omitted illustrative working papers because of the availability of their book, *Accountants' Working Papers*, and have confined their chapter on working papers to a discussion of the gen-

(Continued on page 307)

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May

1953

A Score Settled...

Sgt. Ronald E. Rosser, U.S. Army



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BOOK REVIEWS

(Continued from page 305)

eral principles and the presentation of a model audit program which is limited to broad procedures. Reference has already been made to the final chapter eighteen on report preparation.

Although the authors are aware of the essential principle that the examination of balance sheet accounts should be correlated with their related operating accounts (p. 24) the presentation does not reflect this integration. The operating accounts are discussed both in the single chapter referred to and in the chapters on the original records, but only casual references to these accounts are made in the nine "balance sheet" chapters. Also worthy of note is that the emphasis which has been placed on the relative competence of evidential matter since Statement on Auditing Procedure No. 1, culminating in the adoption of the related auditing standard, is not reflected in the book. Of paramount importance to the novice in auditing is the clear presentation of the multiplicity of underlying records and documents in support of the transactions and accounts, and a meaningful explanation of their relative reliability. In this connection, the authors limit their discussions, for the most part, to such "surface" documents as payroll sheets (p. 69) and sales invoices (p. 141), while the extended procedures as related to bank confirmations (p. 101) and confirmation of notes receivable (p. 129) appear to have been minimized.

The practitioner will find of special interest the suggestions as to the scope of examination under varying conditions of internal control which are incorporated in the model audit program. Thus, for example, with respect to the footing of the total column of the sales record the following is the suggested scope: "Minimum, sufficient part of last month to afford satisfactory evidence of internal control. Medium, 3 non-consecutive months, including last month. Bad, 6 months." By these suggestions and many others of similar nature and equal interest do the authors evidence the achievement of their objective of a practical presentation of the subject.

BENJAMIN NEWMAN

Adelphi College
Garden City, N. Y.

**Proceedings of New York University
Eleventh Annual Institute on Federal
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Edited by Henry Sellin, MATTHEW BENDER
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Book Reviews

(Continued from page 307)

tion of its predecessors for presenting only top-flight, fully annotated and documented, practical treatises on current tax problems, compiled by eminent tax practitioners. Seventy-two papers are included, under the following thirteen subject groupings:

Problems of the Personal Investor, Management Problems of the Operating Business, Operating Problems of the Operating Business, Industry Problems, Corporate Reorganization, Stockholder and Corporation, Estate Planning, Fraud Problems, Procedure, Business Sales and Purchases, Excess-Profits Taxes, Bureau and Code Reorganization, and Problems of the Individual. An Index to the volume is also included, and a separate consolidated index covering volumes 5 through 11 will soon be available.

The study and thinking included in this and the previous volumes will save any tax practitioner many weary hours of time-consuming and costly research. This reviewer will gladly attest to this from personal experience; indeed, a tax problem which he was currently investigating was the subject of an excellent analysis in the eleventh volume. It is getting monotonous to say that this series of volumes belongs in the library of every tax practitioner.

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

VOL. XXIII

May • 1953

No. 5

New York City Local Taxes

By DAVID ZACK, C.P.A.

THE pressure of New York City local taxes on taxpayers has grown tremendously in recent years. This increased impact results from the City's ever-increasing need for revenue with resultant higher rates, new types of taxes, and tighter and more ingenious enforcement. When the larger bite of municipal taxes is coupled with decreasing profit margins and increasing overhead, the taxpayer and his tax advisors become acutely interested in

the technicalities of municipal and local taxation.

The Committee on Municipal and Local Taxation of the Society sought to help satisfy this professional interest by means of a technical meeting on December 2, 1952. The top tax enforcement officials of the New York City Bureau of Excise Taxes were kind enough to cooperate in this venture. They were lavish in the time, effort and energy which they expended in their preparations for this meeting and the Committee and the Society want to take this opportunity to express publicly their appreciation of the splendid cooperation extended by Special Deputy Comptroller Morris W. Weiner and his staff in the presentation of their papers.

The extreme interest in the subject matter of the technical meeting and the papers presented thereat, warrants the publication of the papers in full in this issue. The material presented in the following articles should prove of tremendous practical help to every accounting and tax practitioner in his day-to-day work.

DAVID ZACK, C.P.A. and attorney, is a member of our Society and of the American Institute of Accountants. He is a member of the Committee on Federal Taxation and he is Chairman of the Committee on Municipal and Local Taxation.

Mr. Zack is the editor of the *Excess Profits Tax Exchange* in *The New York Certified Public Accountant*. He is a Lecturer on Taxation at the City College (New York) School of Business and Civic Administration and at the New York University Institute on Federal Taxation. He is a partner in the firm of David Berdon & Co., Certified Public Accountants.

Procedures in Audits, Appeals and Refunds

Sales and Compensating Use Taxes

By LOUIS GOODGOLD, C.P.A.

THE powers to make audits, to grant hearings on appeals and to authorize refunds, together with all other powers conferred upon the Comptroller under the City's Excise Tax Laws, have been delegated by the Comptroller to a Special Deputy Comptroller, who is the chief executive officer of the Bureau of Excise Taxes, which is charged with the administration of these laws. The following is a factual presentation of the Bureau's procedures in audits, appeals and refunds insofar as it relates to the Sales and Compensating Use taxes.

Audit Procedure

All audits made by the Bureau, with the exception of those made by the Bulk Sales Unit, are conducted in the field, and cover a three-year period, except in those cases where the taxpayer has been engaged in business for a shorter period. In such event, the audit covers the period during which the taxpayer was so engaged. In every case where

the required returns have not been filed or where the returns which have been filed are willfully false, and although the periods covered thereby are beyond the three-year statutory period, they nevertheless are included in the audit.

Simultaneously with an audit of the returns of a taxpayer filed under any Excise Tax Law, audits are made of the returns of said taxpayer filed under all other Excise Tax Laws pursuant to which it is subject to tax.

To illustrate: A hotel is engaged in the business of renting rooms. In connection therewith, it sells food and certain utility services, such as electricity and telephone. Simultaneously with an audit of its sales tax returns, audits are also made of the returns required to be filed by said hotel under the Compensating Use Tax Law, the Gross Receipts Tax Law, the tax on the Occupancy of Hotel Rooms, and the Utility Tax Law.

Every sales tax audit comprises the following:

- (1) A verification of gross receipts reported.
- (2) A verification of claimed deductions.
- (3) A verification of taxes collected or required to be collected.
- (4) An examination of invoices relating to purchases of tangible personal property carried as fixed assets and those relating to purchases of tangible personal property treated as expense purchases for the purpose of ascertaining whether the sales or use tax has been paid on such purchases.

Verification of Gross Receipts

The Bureau generally will accept as correct the gross receipts reflected on a taxpayer's records where said records are adequate and complete and, in connection therewith, the taxpayer em-

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employs a proper system of internal and external audit control. However, if the receipts reflected on the records are in excess of the receipts reported, the unreported amount will be assessed, unless satisfactory evidence is submitted to show that such unreported amount represents non-taxable receipts.

Subdivision (i) of Section N41-2.0 of the Sales Tax Law, in part, provides as follows:

"For the purpose of the proper administration of this title and to prevent evasion of the tax hereby imposed, it shall be presumed that all receipts for property and services mentioned in this section are subject to tax until the contrary is established, and the burden of proving that a receipt is non-taxable hereunder shall be upon the vendor or the purchaser ***"

(See also: *Disler v. Dept. of Revenue*, Mich. B.T.A., 8-11-49; *Marie's Restaurant v. Glander*, Ohio B.T.A., 1-24-49.)

Where a vendor's records do not properly reflect his gross sales, such sales may be determined by a purchase audit. Books of record are not self-proving and, in the absence of proof of their accuracy, the Bureau's determination of their accuracy will be sustained by the Courts. Similarly, where the vendor maintains inadequate records, or has no records, the Bureau's determination of the correct amount of sales in accordance with any of the following methods will be sustained by the Courts:

(1) Purchase audit method.

(2) The application of the inventory turnover and the gross profit on sales of businesses of a similar nature to that of the taxpayer, which information is obtainable from published reports by Dun & Bradstreet or from the experience of the Bureau, to the known average inventory of the taxpayer.

(3) The acceptance of the receipts for any given year for which the records are complete as the receipts for each of the other years for which the records are missing, and

(4) The determination as the correct amount of gross receipts the total

cash deposits, plus cash receipts not deposited.

(*Bishoff v. Commissioner*, 27 F 2nd 91; *Warner Bros.*, Wis. B.T.A. 6/17/52; *W. M. Cafaro & J. A. Cafaro, d/b/a Ritz Bar v. Peck*, Ohio B.T.A., 2/14/52; *Johns, d/b/a Georgis Restaurant v. Peck*, Ohio B.T.A. 2/14/52.)

Verification of Deductions

The law specifically exempts from the tax receipts from certain sales and services set forth in Section N41-2.0 which need not be repeated here. Such receipts, nevertheless, must be included in the gross receipts reported on the vendor's return, and may be taken as a deduction on said return. Every type of claimed deduction must be separately set forth on the return. The lumping in one amount of all claimed deductions is in violation of the law and the regulations. The Bureau looks with disfavor upon a return which shows only a vendor's net taxable receipts, and, in certain instances, may regard such return as one not filed as provided by law. In such case, the Statute of Limitations may not be regarded as a bar to an audit of the return, even though it covers a period outside the statutory period.

Since the Sales Tax is, in fact, a tax on every taxable transaction, and since millions of returns are filed annually with the Bureau, it is a physical impossibility for the Bureau with its limited auditing staff to make complete detailed audits. In any event, complete detailed audits are not desirable for the reason that they impose undue burdens, both on the Bureau and the taxpayer.

As an alternative, the Bureau resorts to the use of the test-check method of auditing employed by professional auditors. It is conceded that, under this method, some taxpayers pay a lesser additional tax and others pay a greater additional tax than they would be required to pay under a complete detailed audit. In the final analysis, the overpayments offset the underpayments;

less time is spent in making the audits; more audits are made; the taxpayer's records and personnel are not tied up for unreasonable periods of time, and the City realizes more revenue.

The legality of the test-check method of auditing has been sustained by the Courts in a number of cases. (*Matter of Gandolfi & Co.*, U.S.D.C., S.D.N.Y., December 6, 1940; *Matter of Garfield Bag & Stationery Co., Inc.*, U.S.D.C., S.D.N.Y., December 9, 1941; *Thomas v. Henneford*, Washington Superior Ct., October 3, 1938; *DuPage Liquor Store, Inc. v. McKibben*, 383 Ill. 276; *Obert-Rosky v. Ezatt*, 145 Ohio State 493.)

The test-check method of auditing, as employed by the Bureau, involves a complete detailed audit of all the transactions of a taxpayer included in a period or periods selected for the test-check. In selecting such test period or periods, consideration is given to the size of the business, the number of transactions during the audit period, the nature of the business, the changes in the method of doing business, the amount of claimed deductions for each class of non-taxable receipts compared with the gross receipts, and such other factors as will enable the Bureau's auditor to make a test, the results of which will be representative of the entire period under audit.

The vendor, in advance of the audit, is required to make ready for audit a schedule or schedules setting forth in detail the deductions claimed by it for the test period and the basis therefor; and submit proof in substantiation thereof. Whenever a percentage of error in the test period for any class of deductions is ascertained, it is applied to the total amount of said deductions claimed by the taxpayer for the entire audit period. A tax deficiency is then assessed on the resulting amounts.

If the taxpayer claims, with reasonable justification, that the period selected for the test-check is not representative of the period under audit, the auditor, with the approval of his superior,

will select another test period for a second test-check. The application of the results of both test-checks depend upon the facts in each case.

Unless there has been a change in the nature of the business or in the method of doing business during the period covered by the audit, the percentages of error for both test-check periods will be averaged and applied as heretofore explained. If there has been a change, the results of each test period will be applied to the respective audit periods covered thereby.

Verification of Tax Collected or Required to be Collected

Pursuant to the power conferred upon the Comptroller, he has by regulation prescribed a schedule of the amounts to be collected from purchasers in respect to any receipt upon which a tax is imposed under the law. The schedule was so prescribed as to eliminate fractions of 1¢, and so that the aggregate collection of taxes by a vendor shall, as far as practicable, equal 3% of the total receipts from the sales and services of such vendor upon which the tax is imposed. It also provides that no tax is required to be collected on amounts of 18¢ and less. The present schedule reads as follows:

On amounts from 1¢ to 18¢—no tax
19¢ to 38¢—1¢ tax
39¢ to 78¢—2¢ tax
79¢ to 99¢—3¢ tax

On each even \$1.00 of purchase—3¢ tax, plus the above rate on the amount in excess of even dollars.

Nothing contained in this schedule forbids a vendor from the collection of a tax on amounts of 18¢ and less. Accordingly, a vendor who chooses not to collect the tax on sales of 18¢ and less must nevertheless pay the tax thereon at the statutory rate. (*Queens Vending Corp. v. City of New York*, 246 App. Div. 594, 1st Dept.)

It is recognized, however, that, under the present schedule, some retailers collect a tax which is more and others collect a tax which is less than the tax

collectible under the 3% statutory rate. It is also recognized that some vendors, because of their methods of doing business and the amounts of their individual transactions, collect no tax whatsoever, e.g., vendors of tangible personal property through vending machines in amounts of 18¢ and less.

Nevertheless, it must be pointed out that the schedule applies to businesses in the City generally, and its effect upon a single, isolated business cannot be regarded as reflective of its general effect as applied, nor be condemned for that reason.

The vendor is required to pay over to the Treasurer the tax charged to its customers or required to be charged, whichever is greater, but not less than 3% of its total taxable sales, including sales in amounts of 18¢ and less. In such case, the vendor is not required to pay an additional tax on taxable sales of 18¢ and less. (*H. L. Green Co., Inc. v. Joseph*, 297 N.Y. 588 (1947).)

Subdivision (e) of Section N41-2.0 of the Sales Tax Law, in part, provides as follows:

"Upon each taxable sale or service, the tax to be collected shall be stated and charged separately from the sales price or charge for service and shown separately on any record thereof at the time the sale is made or evidence of sale issued or employed by the vendor and shall be paid by the purchaser to the vendor as trustee for and on account of the City, and the vendor shall be liable for the collection thereof and for the tax * * *."

Section N41-4.0, in part, provides as follows:

"Every person shall keep records of receipts and of the tax payable thereon and also records of purchases in such form as the Comptroller may by regulation require. * * *"

Where a vendor complies with the foregoing sections of law, the Bureau, upon audit, will select the transactions of the vendor for a given period as a test-check. The tax required to be collected on every such transaction will be computed. If there is a resulting per-

centage of error in the total amount of tax charged, it will be applied to the total tax paid over for the entire audit period, and the resulting amount will be assessed.

Where a vendor does not pay over to the Treasurer the tax required to be charged, but pays over the tax computed at the statutory rate, or on any other basis which is less than the tax required to be charged, the Bureau will disregard the vendor's method of computing the tax and determine and apply the actual rate of tax collections to the vendor's total taxable sales for the audit period. Similarly, where the vendor, in violation of the law or regulations, fails to maintain the required evidences of sale or the records of the receipts and the taxes payable thereon, the Bureau will determine the actual rate of tax collections from external indices and apply the same to the vendor's total taxable sales.

Examination of Purchase Invoices

In connection with every audit, the Bureau will examine the invoices pertaining to the purchases of tangible personal property carried on the books of the taxpayer as fixed assets to determine whether the taxes due thereon have been paid by the taxpayer as a vendee.

An examination will also be made of the invoices pertaining to the purchases of tangible personal property, other than fixed assets, not purchased for resale. Unless such invoices are too numerous, they will be examined in detail; otherwise, the test method of auditing, as heretofore described, will be used to determine any tax deficiency due thereon.

If the taxpayer fails to submit purchase invoices for examination, it will be assessed for the tax, computed at the statutory rate, on the total amount thereof, as reflected by the books of account.

Under the Sales Tax Law, the purchaser is required to pay the tax on

every purchase of tangible personal property purchased for any purpose other than for resale in the form of tangible personal property and delivered to it in the City of New York. It makes no difference that the property purchased was delivered to the purchaser from a vendor's source of supply outside the City, or that the vendor did not maintain a regular place of business in the City. If the property purchased was delivered to the purchaser outside the City and it was subsequently used by the purchaser in the City, the purchaser, nevertheless, is required to pay the Compensating Use Tax. The purchaser derives no advantage whatsoever, taxwise, by making its purchases from a source outside the City or taking delivery thereof outside the City if the property so purchased is used in the City. As a matter of fact, in such cases, it may be to the disadvantage of the purchaser.

Where a vendor fails to collect the tax from a purchaser, the latter is not relieved from the obligation of paying the tax to the Treasurer. The vendor is merely a tax collector and not the actual taxpayer. The tax falls on the purchaser.

Where the vendor collects the tax from the purchaser, the City is without power to collect the same tax from the purchaser. This applies, even though the vendor fails to pay over the tax collected to the Treasurer. Where a vendor fails to collect the tax from the purchaser, but pays the tax to the Treasurer, the City is without power to collect the same tax from the purchaser. The City is entitled to collect the tax only once on each sale. (*Matter of Fifth Avenue Building Co. v. Joseph*, 297 N. Y. 278, decided April 22, 1948.)

Upon completion of an audit, and after the taxpayer has been apprised of the auditor's findings, he may agree therewith and execute a waiver and consent to the tax shown to be due.

If the taxpayer disagrees with the auditor's findings, he may contest the

same, in which case, he is afforded every opportunity to submit additional evidence in support of his contentions. Such evidence may be submitted to the auditor, or to his group chief in the field, or to the auditor's immediate superiors in the office of the Bureau. Where an agreement is not reached at this stage, the taxpayer may request a further conference with the Assistant to the Special Deputy Comptroller for said purpose.

In every case where an agreement is reached, the taxpayer is required to sign a waiver and consent for the amount of tax claimed to be due. Every such waiver and consent assessment is subject to review by the auditor's immediate superiors and the Reviews Unit, and is not final until approved by the Special Deputy Comptroller. Where the latter approves such waiver and consent assessment, a notice of a consent determination stating that the Comptroller has confirmed the waiver and consent assessment for the periods audited, and setting forth the respective amounts applicable to each such period, is mailed to the taxpayer. This notice is final and irrevocable, and the amount of tax fixed therein must be paid to the City Treasurer on or before the date indicated. Interest and/or penalties, as the case may be, is added to the amount of tax due.

There are certain sections in the laws which deserve special attention because they are not generally known by the average tax practitioner and the public at large, and are availed of by the Bureau wherever applicable in connection with audits.

Officers' Liability for Taxes

Sections N41-17.B of the Sales Tax Law and M41-18.0 of the Compensating Use Tax Law, in substance, provide that officers of a corporate vendor shall be personally liable for the tax collected or required to be collected by such corporation, and subject to the penalties therein provided.

The Bureau takes the position that any person holding an office provided by the by-laws or other instrument governing the affairs of a corporation, or who has exercised the functions of such office, shall be deemed to be an officer of said corporation for assessment purposes; also, that all such officers are jointly and severally liable for the tax for the period during which they were officers.

The sections of the laws to which I have referred are enforced in all cases where it is ascertained upon audit that there is danger that the corporation will not pay the tax due the City because it is about to dissipate its assets, or is insolvent, or bankrupt. The fact that a corporation is insolvent or has been declared a bankrupt does not abate in whole or in part the liability of the corporate officers. Such liability continues unabated until the tax has been fully paid. Assessments against corporate officers under the Statute of Limitations run concurrently with the assessment against the corporation of which they are officers.

Bulk Sales

An additional liability for Sales and Compensating Use Taxes attaches to a purchaser in every case where there is involved a bulk sale. Under Sections N41-11.C of the Sales Tax Law and M41-27.C of the Compensating Use Tax Law, a bulk sale takes place whenever there is made a sale in bulk of any part or the whole of a stock of merchandise, or of fixtures, or of merchandise and fixtures, pertaining to the conducting of the business of the seller other than in the ordinary course of trade. In such case, the purchaser is required, at least ten days before taking possession of the merchandise and/or fixtures, or paying therefor, to notify the Comptroller by registered mail of the proposed sale and the price. In case of failure to give the required notice, or whenever the Comptroller shall inform the purchaser that a possible claim for such taxes exists, any

sum of money, property or choses in action, or other consideration required to be paid over to the seller, is subject to a first priority right and lien for any such tax theretofore or heretofore determined to be due from the seller. The purchaser is also forbidden to transfer to the seller any sums of money, property or choses in action to the extent of the City's claim. For failure to comply with these provisions, the purchaser becomes personally liable for the payment to the City of any such taxes. The amount of such taxes is limited to the purchase price of the assets acquired from the immediate predecessor.

To avoid liability on the part of the purchaser for the payment of any tax due by the seller, the purchaser should make certain that proper notice of the proposed sale is given to the City and a sufficient sum to cover such tax is withheld from the seller until the latter's records have been audited by the Bureau and any tax found due is paid over to the City.

Interest and Penalties

Whenever a tax deficiency is asserted upon audit, penalties and/or interest may be added thereto. Under Sections N41-17.O of the Sales Tax Law and M41-33.O of the Compensating Use Tax Law, the Comptroller is empowered to impose penalties at the rate of five (5%) per cent of the amount of tax due, plus interest at the rate of one (1%) per cent of such tax for each month of delay, except the first month, if such tax is not paid over within the time required by law. But, if the Comptroller is satisfied that the delay was excusable, he may remit all or any part of such penalties, but not interest at the rate of six (6%) per cent per annum.

Illegal Shifting of the Burden of the Tax

Under Section N41-2.O of the Sales Tax Law, the tax is imposed upon every taxable retail sale. The person

liable for the payment of a sales tax upon the purchase of tangible personal property at retail may not shift the burden of the tax to another. Where such person does shift the burden of the tax to another, he, nevertheless, is liable for the payment of the tax as a vendee on the purchase price of the property, and such liability for tax will be asserted upon audit.

To illustrate: A contractor engaged in the performance of a lump sum contract for the repair or improvement of real property is required to pay the Sales Tax as a retail customer on the purchase price of all the tangible personal property used by him in the performance of the contract. If, instead of paying the tax as a vendee, he collects the tax from his customer and pays it over to the City as a vendor, the City is not barred from asserting its claim for the tax against the contractor as a vendee. The tax illegally collected by the contractor from his customer and paid over to the City will not be permitted as an offset against the tax asserted by the City against the contractor as a vendee.

Collection of Tax under Regulation Believed by Vendor To Be Void

Where a vendor collects a Sales Tax in accordance with the rules and regulations promulgated by the Comptroller, it may not keep it merely because it believes the regulation to be void or inconsistent with law. Any refusal on the part of the vendor to pay over to the Treasurer the tax collected would unjustly enrich the vendor. The money thus collected is on the declaration of the vendor that its customers were paying the tax for transmittal to the City. A vendor who has collected the tax is not bound to ascertain whether the Comptroller's Regulations went beyond the limitations of law. The Sales Tax is not imposed on the vendor. The vendor is merely a tax collector and not the actual taxpayer. The tax falls on the purchaser, and the purchaser has a direct remedy against the Comptroller for a refund (*Matter of*

Kesbec, 278 N.Y. 293; *Matter of Merchants Refrigerating Co. v. Taylor*, 275 N.Y. 113; *Cook v. Sears Roebuck & Co.*, Ark. Sup. Ct. 11-17-47).

Upon audit, all taxes thus collected by the vendor and not paid over to the Treasurer will be assessed against the vendor.

Hearings on Appeals

If, upon completion of an audit, an agreement is not reached, penalties will be added to the amount of tax due, and a thirty-day notice of determination, often referred to by the Bureau as a formal notice of determination, will be issued. Every such notice of determination is given to the person liable for the collection and/or payment of the tax. Such determination finally and irrevocably fixes the tax unless the person against whom it is assessed within thirty days after the date of notice shall apply to the Comptroller in writing for a hearing, or unless the Comptroller, of his own motion, shall re-determine the same. Upon receipt of such application, it is immediately acknowledged, and a date for the hearing is fixed. Such hearing is conducted by the Hearings Unit of the Bureau, which, for administrative purposes, is divided into two divisions, one for the holding of informal discussions, and the other for formal hearings.

At the hearings, a taxpayer may appear in his own behalf or be represented by another. In the latter case, such representative must submit a proper power of attorney. If the person liable for the tax or his duly authorized representative fails to appear on the date fixed for the hearing, a notice of a final determination which is irrevocable is mailed to the person liable for the tax, and a copy thereof forwarded to the City Treasurer for collection.

If the person liable for the tax or his representative appears for the hearing on the date fixed, the case is assigned to a conferee in the Informal Hearings Division, where the taxpayer is again afforded every opportunity to submit evidence to substantiate any contentions he may make for the abatement

of the tax in whole or in part. If an agreement is reached, the taxpayer is required to sign a waiver and consent assessment for the amount of tax due. The informal conferee prepares his report, which is subject to review by the Reviews Unit and Tax Counsel, after which the report is submitted to the Special Deputy Comptroller for his signature. Upon approval by the Special Deputy Comptroller, a notice of a final consent determination, which is irrevocable, is mailed to the person liable for the tax, and a copy thereof forwarded to the City Treasurer for collection. The tax due must be paid to the Treasurer on or before the date indicated thereon.

In the event an agreement is not reached at the informal hearings, the case is transferred for formal hearings to the Formal Hearings Division. At such hearings, the taxpayer may appear in his own behalf or be represented by an attorney-at-law. The City is represented by a formal hearing conferee, who acts as presiding officer, and a representative of the office of the Corporation Counsel. The witnesses are sworn and a record of the minutes is made. Copies of the transcript of the minutes may be obtained upon payment therefor at the rate of 50¢ per page.

Upon the conclusion of the hearings, the conferee prepares his report, which is submitted to Tax Counsel for approval. If the latter approves the same, a final notice of determination, signed by the Special Deputy Comptroller, which is irrevocable, is mailed to the taxpayer, and a copy thereof forwarded to the City Treasurer for collection. The determination of the Comptroller is reviewable for error, illegality or unconstitutionality, or any other reason whatsoever, by a proceeding under Article 78 of the Civil Practice Act, if application therefor is made to the Supreme Court within thirty days after the giving of the notice of such determination. A proceeding under Article 78 of the Civil Practice Act may not be instituted unless the amount of any tax sought to be reviewed with penalties and interest thereon, if any, shall be

first deposited with the Treasurer, or, at the option of the applicant, it may file an undertaking with the Comptroller from such surety as a Justice of the Supreme Court shall approve, in a sum sufficient to cover the taxes, penalties and interest thereon as set forth in such determination, plus the cost and charges which may accrue against it in the prosecution of the proceeding.

The Courts have held that the remedies provided for in the law are not exclusive, and that an action for a declaratory judgment may be instituted in those cases where the constitutionality of the Statute is challenged or the Statute, by its own terms, does not apply to the particular case. In such cases, questions of law only may be raised. (See: *Dun & Bradstreet Inc. v. City of New York*, 276 N.Y. 198; *Booth v. City of New York*, 296 N.Y. 573; *Stampers Arrival of Buyers Inc. v. City of New York*, 296 N.Y. 574; *All American Bus Lines v. City of New York*, 296 N.Y. 571.)

Refunds

The Treasurer, upon the order of the Comptroller, will refund or credit, without interest, any tax, penalty or interest erroneously, illegally or unconstitutionally collected or paid, if application to the Comptroller for such refund or credit is made within one year from the date of payment thereof. Under the existing law, notice of protest is not required.

Persons Who May Make Application for Refund or Credit

An application for refund or credit may be made by any of the following persons, as the case may be:

- (1) A vendor who collected the tax from his purchaser and paid the tax so collected to the Treasurer.
- (2) A purchaser who paid the tax to his vendor, provided the latter paid the tax to the Treasurer.
- (3) A vendor who did not collect the tax from his purchaser, but paid the tax to the Treasurer.
- (4) A purchaser who paid the tax directly to the Treasurer.

Application and Requirements

(1) No special form of application for the filing of a claim for refund or credit has been prescribed by the Comptroller. However, an application for refund or credit must be in writing and signed by the applicant or his duly authorized agent and, if signed by an agent, must be accompanied by a power of attorney from his principal.

(2) The application must set forth the grounds upon which the claim for refund or credit is made.

(3) Where the applicant is a vendor who collected the tax from his purchaser and paid the tax so collected to the Treasurer, or the applicant is a purchaser who paid said tax to his vendor, the application must show on its face that it has been filed with the Comptroller within one year from the date of payment of the tax to the vendor. The allegation of payment, in the application of the vendor, must be substantiated by cancelled checks or photostatic copies thereof, or other evidences of payments of the tax to the Treasurer and repayment of the tax to the vendor's purchaser. The allegation of payment of the tax, in the application of a purchaser, must be substantiated by cancelled checks or photostatic copies thereof, or other evidences of payment of the tax by the purchaser to his vendor, and the payment over of the tax by the purchaser's vendor to the Treasurer. In such cases, whenever the Comptroller approves a refund or credit, he may require general releases to the City from both purchaser and vendor before authorizing the Treasurer to make any refund or grant any credit.

Where the applicant is a vendor who did not collect the tax from his purchaser, but paid the tax to the Treasurer or the applicant is a purchaser who paid the tax directly to the Treasurer, the allegation of payment must be substantiated by a cancelled check or a photostatic copy thereof, or other evidence of payment of the tax by the ap-

plicant to the Treasurer. The Treasurer may, in lieu of any refunds required to be made, allow credit therefor.

The Comptroller reserves the right to audit the applicant's books and records prior to the making of any refund, or he may grant the refund or credit subject to audit.

The granting of a refund or credit before audit is without prejudice to the right of the Comptroller to determine, after audit, the applicant's right to the refund or credit and his liability for tax.

The Comptroller will deny any application for refund or credit where he determines that the statutory requirements have not been met or that the grounds set forth in the application are without merit. An application for refund or credit shall be deemed an application for a revision of any tax, penalties or interest complained of, and the Comptroller may receive evidence with respect thereto.

The Comptroller will make his determination and give notice thereof to the applicant. The Comptroller's determination may be reviewed by a proceeding pursuant to Article 78 of the Civil Practice Act, providing such proceeding is instituted within thirty days after the giving of notice of such determination, and provided that a final determination of tax due was not previously made. Such a proceeding shall not be instituted unless an undertaking is filed with the Comptroller for such amount and from such sureties as a Justice of the Supreme Court shall approve, to the effect that, if such proceeding is dismissed or the tax confirmed, the petitioner will pay all costs and charges which may accrue in the prosecution of such proceeding.

A person shall not be entitled to a revision, refund or credit of a tax, interest or penalty covered by a determination of tax for which he has had a hearing or an opportunity for a hearing as provided by law, or has failed to avail himself of the remedies therein provided.

New York City Gross Receipts Tax Problems Involved in Multiple Corporate Organizations

By MAX BROFMAN

BECAUSE of the trends in modern business methods, and, in some cases, because of the accrual of legal and tax benefits, the use of multiple corporate organizations in carrying on business activity has been greatly extended, with corresponding legal, economic, and tax problems. While numerous and varying tax problems may arise from multiple corporate transactions, limitations of time, space and purpose require that only some of the important problems be presented, particularly those which may be of general interest.

For the purpose of clarity, the term "multiple corporate organizations," as used in this discussion, means two or

more corporations which are affiliated with each other by virtue of stock ownership or other control, or which enter into such close business or legal relationships with each other as for all intents and purposes it may seem that they operate as one or for the benefit of each other, though they may be non-affiliated and have separate and independent profit motives.

In considering the impact of the New York City General Business and Financial Tax Law upon the receipts and transactions of multiple corporate organizations, the chief problem that arises is the determination of the nature of the legal relationship between the parties. For, the extent to which receipts from such transactions may be subject to tax depends upon the nature of such relationship.

In determining the nature of the relationship between multiple corporate organizations, certain questions immediately present themselves. Is the relationship one of principal and agent, or of vendor and vendee, or of independent contractor, as though the corporations involved were unrelated to each other and acting at arms length? Resolution of these questions generally suffices to resolve the extent of taxability. In developing the problems involved, the discussion herein will be devoted to the usual common relationships that have come before the Bureau, particularly in the last several years. Most of these situations center around corporations having accommodation transactions and intercompany transactions. They also involve collateral problems relating to transfers and profits on mergers or liquidations.

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This paper was presented by Mr. Brofman at a technical meeting of the Society held at the Engineering Societies' Building on December 2, 1952, under the auspices of the Committee on Municipal and Local Taxation.

(1) Accommodation Transactions

Article 220 of the Comptroller's Regulations does not define an accommodation transaction as such. It provides that receipts from accommodation sales or from transactions of an accommodation nature are subject to the tax, even though no profit may be realized from such transactions. This embraces a situation where a corporation purchases goods ostensibly for its own account, but in reality for itself and/or for the account of other corporations (affiliated or non-affiliated) engaged in the same line of business and whose funds or credit standing are limited. Thus, Corporation A may order from X certain goods which A directs to be delivered in certain quantities to Corporations A, B and C. X bills A. A pays X. Thereafter, at the end of stated intervals, Corporation A bills Corporations B and C at cost for the goods shipped to them by X. Though Corporation A made no profit from the transactions, its relation to B and C is that of vendor and its charge to B and C represents an accommodation sale, the receipts from which are taxable. (*Matter of Kerner Coal Co. v. McGoldrick*, 257 App. Div. 821). Such transactions are often arranged to afford the purchaser and its associates the advantage of lower prices due to quantity purchases, and possibly better terms of payment. The relationship of the parties to such transactions is that of vendor and vendee, in the absence of clear proof of a joint venture or a principal-agent relationship.

Article 220 provides, however, that where two persons, engaged in the same type of business, occasionally effect an exchange or loan of inventory or stock in trade, as in the case of an emergency, the receipts from such transactions are not subject to the tax provided that (1) the transactions are casual and infrequent, (2) the transactions are not entered into for profit, and (3) the transactions are in the nature of loans for the purpose of meeting emergencies. While such transac-

tions are an "accommodation," nevertheless, the Comptroller has liberally construed the law and chosen not to treat such transactions as sales but rather as loans of property in exchange for the same or similar property.

(2) Intercompany Transactions

(a) In General

More important and more frequent in occurrence, however, are transactions between two or more corporations that are related to each other by virtue of stock ownership or some other form of control. These are frequently known as intercompany transactions. In these cases it is argued that no taxable receipts result from the transactions between the companies because the transactions are without profit, but are rather for reasons of economy, tax avoidance, or that a principal-agent relationship exists in which the charge of the agent represents reimbursements for advances by him. Intercompany transactions involve either sales of goods or services rendered by one company to another, or charges by one company to another affiliated company for a proportionate share of expenses incurred in maintaining and furnishing certain facilities or services.

Article 221 of the Comptroller's Regulations provides for the taxing of receipts from intercompany transactions, that is, transactions between affiliated companies, even though no profit may be realized therefrom. The cue to taxability is a finding that a charge was made for the sale of goods or rendition of services by one company to another, or for a proportionate share of the expenses incurred in using certain facilities or services. These facts are very often gathered from billings between the companies or entries in the books of account of the companies. Thus, where a company furnishes to its affiliated company, at cost, the materials necessary to manufacture a product, the charge therefor represents a receipt from a sale of tangible personal

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property, which is subject to the tax. Or, where the employees of a parent corporation are assigned to render services for both itself and/or its subsidiary corporations, the latter being charged with a proportionate share of the costs of the parent corporation, the amount of such charges represents taxable receipts to the parent corporation and not mere reimbursements for advances. An examination of a few of the cases in which some of these questions have arisen will clarify the application of the rule.

In *Matter of Bush Terminal Building Co. v. City of New York*, 93 Fed. (2) 661, a subsidiary corporation furnished steam to its parent corporation at cost. The transaction was treated by both companies in their books of account as a sale. The court sustained the tax imposed on the receipts from such sale. This question arose in connection with the city utility tax, which in theory does not substantially differ from the gross receipts tax. The taxpayer's claim and its disposition is revealed in what the court held (p. 663):

"The debtor and the appellant are separate entities, and there is no occasion to apply the rule which allows the corporate fiction to be disregarded. It should be preserved here. (Citing cases.) The intercorporate relations of the two companies may have been arranged to gain certain advantages, but that will not avoid the tax in this case. See *Douglas & Shanks, 'Insulation from Liability through Subsidiary Corporations,'* 39 Yale Law Journal, 193. There is no legal obstacle against regarding the sale of this steam from a subsidiary to a parent company as a purchase and sale. Since the subsidiary sold or furnished steam to the parent company, the sale is taxable under Local Law No. 21 of 1934 as amended by Local Law No. 2 of 1935. The appellant and its parent company's plan of separate corporations for the conduct of their various activities presumptively is for some gain or advantage, and being separate entities, under the circumstances, appellant is not permitted to deny the right of the appellee to tax for the services rendered. See *Fourche River Lumber Co. v. Bryant Lumber Co.*, 230 U. S. 316, 323, 33 S. Ct. 887, 57 L. Ed. 1498; *Jackson v. Hooper*, 76 N. J. Eq. 592, 75 A. 568, 27 L.R.A., N.S., 658. We also

find there was no joint adventure in the production and sale of the steam."

A simple application of the rule that intercompany transactions constitute a sale may be found in the case of *Matter of New York Merchandising Co., Inc. v. McGoldrick*, 261 App. Div. 957. In that case the taxpayer manufactured cameras which it sold in a finished state to its affiliated company, the Universal Camera Corp. The taxpayer went out in the open market and purchased in its own name the component parts of the finished camera. The camera was manufactured by employees of the taxpayer. The finished cameras were then transferred to the Universal Camera Corp., and bills were rendered at cost for finished products as they were sold by the Universal Camera Corp. The transactions between the taxpayer and its affiliated company were listed in a purchase account and were described as sales. The Universal had no working capital, no funds and no credit in the open market. The taxpayer provided all sales credits, bookkeeping, accounting and shipping facilities for which Universal agreed to pay taxpayer 10% of its gross receipts from sales. The main question was whether the charges made by taxpayer to Universal represented receipts from sales, or repayments of loans since the taxpayer contended that it acted as a mere financial agent for Universal and that its receipts from Universal were "mere reimbursements for advances." On the evidence before him the Comptroller held that the receipts were from sales by taxpayer to its affiliated company. The fact that the companies were related to each other did not render the transactions any the less sales.

As already stated, very often in connection with these intercompany transactions the claim is made that one of the companies acted as a mere agent for the affiliated company and that whatever receipts were derived from its operations were as agents. This was partly the claim made in the *New York Merchandising Co., Inc.*, case. That

issue was more substantially involved in the *Matter of Interboro News v. McGoldrick*, 283 N. Y. 49. In the latter case the question was whether the taxpayer acted as agent for non-affiliated publishers or on its own account in the sale of magazines to news dealers. The taxpayer was a distributor of magazines for a number of publishers. The taxpayer argued that the contract between it and the publishers made it an agent, and stressed the following facts: (a) that the publishers fixed the prices for their respective magazines; (b) that employees of the publishers had access to taxpayer's files of orders; and (c) that the magazines were not carried as an asset on the taxpayer's books but entered in the stock record. On the other hand, the Comptroller emphasized the following facts: (a) all agreements with local dealers were negotiated by the taxpayer in its own name; (b) all deliveries were made from its own warehouses in its own trucks by its own employees; (c) all payments were made to it and were acknowledged by it in its own name and deposited by it in its own general bank account. While the prices were fixed by the publisher, the taxpayer was obligated to remit a smaller amount to the publisher, the differences representing the compensation of the taxpayer. The court examined the contracts and found that by themselves they did not establish a relationship of principal and agent and that it was essential to examine the facts. The court analyzed the facts, observing that the conflict of evidence was to be composed by the Comptroller. By virtue of that provision of the local law creating a rebuttable presumption of the taxability of all receipts and putting the burden of proof to the contrary upon the persons making such claim, the court found that the Comptroller was warranted in his conclusion that the taxpayer did not act as agent but for its own account.

The situation just described must be distinguished from that where a strict

principal-agent relationship exists. Article 224 of the Comptroller's Regulations requires an agent to report as gross receipts only the commissions withheld by him for his services, but it also prescribes the following conditions which must appear before a principal-agent relationship can be deemed to exist: (a) that the contract clearly establishes the relationship of principal and agent; (b) that the books and records of the agent show the name of the actual owner of the property in whose behalf the sale is made; (c) that the credit risk is assumed by the actual owner of the property; (d) that the books and records of the agent show the amount of gross sales and the amount of commission due thereon; (e) that the invoice shows that the sale was made as agent of or for the actual owner. These conditions, however, need not necessarily be present in cases of factors and commission merchants, such as are described in Article 306 of the Regulations, and who are subject to the financial tax.

As was demonstrated in the *Interboro News* case, the finding of the Comptroller on any disputed question of fact relating to the existence of such relationship is final, if there is ample "warrant in the record" and a "reasonable basis in law." (*Matter of Mounting & Finishing Co., Inc. v. McGoldrick*, 294 N. Y. 104.)

A rather interesting case recently arose wherein a question was presented as to whether the relationship between parent and subsidiary corporations was one of principal and agent, or rather of parent and subsidiary companies, each acting independently under a contract between them. The parent corporation was a holding company and entered into a contract with each of its subsidiary companies to manufacture some products. Each subsidiary had the right to manage and operate the plants belonging to the parent corporation and to market and sell the products thereof. The parent corporation furnished the necessary facilities of

working capital and executive supervision. In return therefor, the parent corporation received all the net profits earned by each subsidiary in excess of a fixed percentage of the subsidiary's capital stock. Not only was there a question as to the liability of the parent corporation for tax on the receipts of the net profits over the fixed percentage earned by the subsidiaries and turned over to the parent corporation, but also the liability of the subsidiary corporations on account of their sales and operations. Although the contract between the parties described the subsidiary companies as agents, the Comptroller found that there was in fact no principal-agent relationship and that the subsidiaries independently manufactured and sold goods under franchises from and through the facilities furnished by the parent corporations; that under these circumstances receipts from the sale of products belonged to the subsidiary corporations and were taxable to them; that the parent corporation was taxable upon the receipts received or accrued from the subsidiary corporations under the intercompany agreement. The receipts of the parent corporation were deemed to arise from the furnishing of facilities and supplementary services by the parent corporation to the subsidiaries, from the furnishing of operating capital by the parent to the subsidiaries, and from the furnishing of patents, copyrights and other benefits to the subsidiaries.

From the foregoing cases the following conclusions are justified: (1) a receipt is taxable if there is any sale made or service rendered whether or not the receipt is in the form of cash, credit, or any other kind of property; (2) it is immaterial on the question of taxability that the parties to the transaction are related to each other either through stock ownership or any other form of control, so long as a sale was made or service rendered, for which a charge is made, by one legal entity to another; (3) it is immaterial that the charge for the sale or service is made at cost or

that there are reciprocal charges between the related companies with a net balance struck; and (4) where the relationship of the parties is claimed to be one of principal-agent, a question of fact is presented, the determination of which by the Comptroller is binding if there is ample "warrant in the record" and a "reasonable basis in law."

(b) Purchasing Agents

In the past few years the Bureau has been confronted with problems involving the tax status of receipts of corporate purchasing agents. These problems arise frequently among affiliated corporations operating a chain of retail stores throughout the United States including the City of New York. Generally speaking, one of a group of affiliated corporations purchases merchandise from various suppliers and furnishes the same to all the other affiliated corporations operating the stores. In addition, it furnishes various services to the affiliated stores.

The problem arises as to whether or not the relationship of principal and agent exists between the purchasing corporation and the affiliated stores, or whether the so-called purchasing agent is acting as an independent vendor of goods to the affiliated stores. If it is acting as a purchasing agent and in behalf of the other stores, then it is only liable for tax on its receipts from commissions and charges for services rendered. If it is acting as a vendor, it is liable for tax on its gross receipts from sales to each store.

Illustrative of the factual situations involving the status of receipts of purchasing agents, the following may be presented. A chain of affiliated retail stores operates throughout the United States, including the City of New York. Each store is separately incorporated. One company owns all the stock of each of the affiliated corporations and is the parent company. Although every one of the affiliated corporations is a separate legal entity, together they form an affiliation of corporations, with the

over-all supervision and management being exercised by the parent company. One of the corporations in the group, not necessarily operating a store, may be designated or regarded by all the others, including the parent company, as a purchasing representative for the other members in the group. For purpose of discussion, this representative will be called a purchasing agent.

The purchasing agent purchases merchandise from various vendors. For this purpose it uses purchase orders which either may be in its name as agent or buying representative, with disclosure of the names of the various principals or in some cases, in the name of the purchasing agent only without any indication as buying agent. The purchase orders are sent to the suppliers, either as result of requisitions, or in some cases, orders, received from the various stores, or, in the discretion of the purchasing agent on the basis of predetermined estimates of the needs of the various stores. Thereafter, the supplier ships the merchandise directly to the stores, or to the warehouse of the agent for trans-shipment to the stores. The shipments to the warehouse are generally for the purpose of inspection and consolidation of shipments to be made to each of the stores. The supplier generally sends an invoice to the purchasing agent, either in the name of the agent, indicating the store or warehouse to which the goods were delivered, or in the name of the affiliated store. In some cases the original invoice is sent to the affiliated store and a copy to the buying agent. Thereafter, the purchasing agent may pay the invoice out of funds advanced by the store on a running account basis, or the affiliated store may pay the invoices directly to the supplier. The purchasing agent, in many cases, may separately bill each store for commissions based upon a percentage of the retail sales of each store, and for other services rendered by the purchasing agent. In some cases, there are no separate charges, but book entries may be made on the books of the purchasing agent

charging each store for the commissions and services rendered with corresponding entries on the books of each store. In other cases, the purchasing agent, where it pays the invoices directly, may bill the stores on the basis of the invoice price and separately charge commissions, against advances previously made by the stores. Corresponding book entries may be made to reflect such billings. The income tax returns filed by the purchasing agent may show only income from commissions and no sales or purchases or inventory. In some cases, the purchasing agent may guarantee payment of the purchases. In other cases, the parent corporation may guarantee purchases.

It is no simple task to determine the true relationship between the parties. It is largely a question of fact in each case. The ultimate conclusion to be drawn depends upon the facts presented and the direction in which they flow. However, in arriving at a determination of the relationship between the parties, certain factors may be considered. The foregoing statement of the nature of the operations of purchasing agents and their affiliated stores suggests what these factors might be. They may be listed as follows: the instruments by which the relationship between the purchasing agent and the affiliated stores is created, whether they be contracts, corporate resolutions, or letter agreements; execution and performance of the contract evidencing such relationship, according to its terms and intent; the form and content of purchase orders used by the purchasing agent; the manner and place of shipments of goods by vendors, and their disposition upon receipt; the form and content of the vendor's invoice together with the identity of the person to whom the vendor sends the same; the identity of the person who pays the vendor; the nature of the entries in the books of account of the purchasing agent and/or the affiliated stores regarding the purchases, disposition of and payment for the merchandise; the form and content of any invoice for charges by the pur-

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chasing agent, either for the goods or for commissions, and the record of payment thereof on the books of account of the purchasing agent; the content of income tax returns filed by the purchasing agent; the form and content of guarantee agreements by purchasing agent or affiliated stores, as well as of insurance policies, if any; the general course of conduct and operations by the purchasing agent and affiliated stores.

All these factors must be closely examined. This requires the presentation by the taxpayer of sufficient and adequate proof. Upon such examination, it may be found that one or more factors may be sufficient to establish or negate the existence of an agency relationship. Once the relationship is determined, the liability for tax is determined. If an agency relationship is established, a purchasing agent is liable for tax on commissions or other charges for services rendered to the affiliated stores. If the relationship of the purchasing agent to the affiliated stores is that of vendor and vendee, the purchasing agent is liable for tax on the gross receipts from sales to the affiliated stores plus any charges for any services it may render. From the foregoing, it must be apparent that the facts in each case determine the nature of the relationship that may exist between the parties. Any one case is not necessarily a precedent for another.

There are situations where a corporation may make arrangements with non-affiliated corporations who desire to avail themselves of the services and purchasing power of the former. In such cases the same problem arises and the same factors must be considered in arriving at a determination of the true relationship between the parties.

(3) Transfer of Assets Upon Mergers or Consolidations As Distinguished from the Sale of a Business in Bulk

Pertinent to the problems presented herein, insofar as corporations are con-

cerned, are the questions of liability for tax arising from the transfer of assets upon mergers and consolidations or corporations, as distinguished from the sale of a business in bulk.

Article 108 of the Comptroller's Regulations provides that if a person subject to tax acquires substantially all of the assets or franchises of, or was merged or consolidated with another person subject to tax, the entity continuing in business shall report as gross receipts or gross income by which the tax is to be measured, the gross receipts or gross income of the predecessor or retiring entity together with its own gross receipts or gross income during the basic period. The intent of this provision is to combine the gross receipts or gross income of the entities involved in a merger, consolidation, or reorganization for the purpose of determining the measure of the tax and place the burden of filing a return and paying the tax on the entity which continues in business. For example: Corporation X decided to absorb its subsidiary, Corporation Y, on March 1, 1951. The assets were acquired and the liabilities assumed as of the date of merger, and Corporation Y was subsequently dissolved. In filing its return on June 15, 1951, Corporation X must measure the tax by its receipts for the entire calendar year 1950 plus the receipts of its subsidiary for such calendar year. Under such circumstances, Corporation Y need not file a return on June 15, 1951. When Corporation X files a return for the following year, it must continue to report on a combined basis. The receipts of the absorbed subsidiary for the months of January and February, 1951, are part of Corporation X's gross receipts for the calendar year 1950 and must be included in its return.

It must be noted, however, that this provision applies only to situations where substantially all the assets or franchises were acquired as a result of

a merger, consolidation, or reorganization, resulting in termination of the business of the corporation whose assets or franchises were so acquired.

The situation described above must be distinguished from the resultant liability arising from the sale of a business in bulk not in the nature of a merger, consolidation, or reorganization. In such case, the seller of the business would be liable for the tax on its gross receipts or gross income up to the date when it sold the business. The purchaser of the business would not be liable for the tax on the gross receipts or gross income of its predecessor (assuming compliance on its part with the Bulk Sale provisions of the law), but would be liable for its own receipts or gross income commencing with the date of the purchase of the business.

The distinction between the two situations given lies in the fact that in the case of transfer of assets upon mergers or consolidations, there is a continuity of identical interests in the merged or consolidated corporation and the remaining entity. Since the remaining entity is liable for all the debts and liabilities (by operation of law) of the merged or consolidated corporation, there is no point in requiring separate returns to be filed by the retiring merged or consolidated companies. This is avoided by the remaining entity including in its returns the receipts of its predecessor company. However, in the case of a sale of a business in bulk not in the nature of a merger, consolidation, or reorganization, there is no continuity of identical interests between the vendor and the vendee, nor is there liability on the part of the purchaser for the taxes of the vendor (again assuming compliance by the purchaser with the Bulk Sale provisions of the law). In such circumstances, it is essential, therefore, that both the seller and the purchaser file separate returns for their respective liability for tax for the periods during which each was in business.

(4) Profits Arising Upon Mergers or From Liquidating Dividends

In connection with the transfer of assets upon a merger or consolidation of corporations, or, the transfer of assets or cash by way of a liquidating dividend upon a complete liquidation of a corporation, some collateral questions may arise involving capital gains to the corporation to whom the assets are transferred. Frequently, upon a merger or consolidation of corporations, the remaining corporation may receive net assets valued at a sum in excess of its cost of the stock of the merged or consolidated corporation. It must be observed that upon a merger or consolidation the stock held in the merged or consolidated corporation is surrendered and cancelled in consideration of the transfer of the assets to the remaining corporation. Where the net assets received by the remaining corporation are valued in a sum in excess of the cost of the stock surrendered by it, it is obvious that a gain results, for which the remaining corporation is liable for a tax. The gain or profit so resulting is equivalent to that realized upon the sale of the stock. (See Article 251 of the Comptroller's Regulations.)

Another interesting observation is that if the merged or consolidated corporation was a going concern whose business was continued and operated by the remaining corporation, the element of good-will should be taken into account and added to the value of the assets acquired by the remaining corporation in determining the profit. Of course, in such case the value of good-will should be determined in accordance with regular accounting practices.

In the case of a corporation which liquidates and as a result declares a dividend in liquidation of the corporation, the dividend so declared and received by the person owning the stock of such corporation is subject to the tax to the extent of the gain realized on the investment. (See Articles 248 and 305 of the Comptroller's Regulations.)

Recent Court Decisions and Administrative Rulings

By HARRY KATZ

CASE law has lately assumed secondary significance in the field of New York City excise taxes. I should hesitate to ascribe this development to the achievement of such complete certainty in applying the law that taxation has become a purely mechanical matter—and doubtless some of you will sympathize with my hesitancy.

The recent ascendancy of administrative decision over judicial decision is due rather to a number of causes, the most influential of which, in my judgment, has been the increase in legislation in this field. Particularly in the year 1952, our local excise taxes have undergone considerable legislative change. This change has been effected not only by the amendment of existing tax laws but also by the adoption of new ones. It is natural in the cir-

cumstances that administrative explanation and clarification are especially needed.

I do not intend to discuss all of those administrative rulings with you this evening, mainly because a number of them are not of sufficiently general interest to warrant such an undertaking. I propose to consider with you only those rulings which I judge to be of the broadest interest as well as most significant. In addition, important cases which have been finally resolved by the courts will be considered.

Uniform Exemption Provisions

The spasmodic development of the New York City excise tax system over the past twenty years could not help but produce some differences among the various local laws where a uniform application would have seemed desirable. Perhaps the most obvious of the differences existed in those statutory provisions which dealt with persons exempt from taxation. For example, the business (gross receipts) tax law exempted, among others, charitable and religious organizations whose income was tax-exempt under the laws of the State of New York; the hotel room tax law granted immunity to organizations created and operated exclusively for religious, charitable or educational purposes, the net earnings of which did not inure to the benefit of any private individual; the sales tax law did not tax "semi-public institutions", which were defined to include charitable and religious institutions supported wholly or in part by public subscriptions or endowment and not organized or operated for profit. While valid reason may have existed for the particular form of each such exemption provision at

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the time of its enactment, such reason soon tended to become obscured. The result was a patchwork of exemptions not easy to administer and which taxpayers often found difficult to comprehend. It was not unusual for a taxpayer to be held exempt from one tax but not from another, because of the difference in statutory language.

Effective July 1, 1952, this unhappy condition was eliminated by the enactment of uniform exemption provisions in the local laws, in compliance with provisions for such standard exemption contained in the State enabling acts.¹ Five public bulletins issued by the Bureau of Excise Taxes this year—Bulletin Nos. 6, 9, 11, 12 and 13 of 1952—relate to the standard exemption provision now applicable to the sales and compensating use taxes, the business tax, the hotel room tax, the retail liquor licensees tax and the motor vehicle use tax, respectively.

In addition to providing for tax immunity to certain governmental organizations, the uniform provision also exempts designated private organizations. It is with the latter that we are here most concerned. Such exemption applies in favor of any corporation, association, trust, fund or foundation organized and operated exclusively for religious, charitable or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation. The provision further states, however, that exemption does not extend to an organization operated for the primary purpose of carrying on a trade or business for profit, whether or not all of its profits are payable to an organization which meets the exemption requirements of the law.

The rulings issued by the Bureau provide that an organization claiming exemption is required to submit such information to the Comptroller as will

enable him to rule upon its status. In general, this information consists of an affidavit setting forth the nature of the organization, the purposes for which it was organized, its actual activities, the sources and disposition of its income, and generally such other facts relating to its operations as may affect its right to exemption. This affidavit must be supplemented by a copy of the charter or articles of association, the by-laws, a financial statement showing assets and liabilities, a statement of receipts and disbursements, and a photostatic copy of a letter from the United States Treasury Department granting the organization exemption from federal income taxation under section 101 (6) of the Internal Revenue Code.

Certainly so far as the sales tax is concerned, the uniform exemption provision represents a liberalization of the law. The former sales tax provision which authorized exemption only in favor of "semi-public institutions" was extremely limited because of the requirement that all or part of the organization's income be derived from public subscriptions or endowment. The same requirement is not found in the present provision.

The new sections should have the beneficial effect of simplifying the application of the local laws from the standpoint of both the taxpayer and the tax administrator. A caveat may be interposed at this point, however. As each local tax is imposed by a separate law, it is necessary for a person claiming exemption to apply for and obtain a separate exemption letter under each law. This does not require a different set of exemption papers for each tax. The same papers will suffice for all, but the application for exemption must indicate specifically the particular law under which the exemption is sought. Failure to obtain a separate letter of exemption under a particular law may mean that the taxpayer's claim to exemption will not be recognized by those with whom he deals.

¹ Laws of 1952, c. 742.

Information Services

Another ruling recently issued, Bulletin 1952-7, is also occasioned by an amendment to the sales and use tax laws which became effective July 1, 1952. This amendment added another category to the sales and services subject to tax under those laws, *i.e.*, information services. Information services are defined to include the services of collecting, compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons.

A brief recital of the background of this new provision will assist in better understanding it. Article 78 of the Sales Tax Regulations provided that persons primarily engaged in the business of rendering a service, supplemented by incidental printed matter for which no additional charge was made, were not engaged in selling tangible personal property and were not required to collect the sales tax from their customers. On the other hand, where any such person sold tangible personal property separate and apart from the service rendered, he was required to collect the tax upon the amount of the receipts therefrom.² Under the Regulation, therefore, it was necessary to determine in each case whether the printed matter was merely incidental to the service or whether the service was a mere incident of the printed matter. As in any situation where a slight difference in degree may yield a wholly different result, the issues posed produced much uncertainty and were a fruitful source of litigation, none of which could be considered as having authoritatively settled the problem.³

The application of the sales and use taxes to information services should have the effect of stabilizing a pre-

viously unsettled area in the law and should eliminate the necessity of making fine-spun distinctions as to whether the element of personal service or the element of property is predominant in a given transaction. As Bulletin 1952-7 points out, the tax is now applicable to every sale of information services involving the furnishing of printed, mimeographed, multigraphed matter or matter duplicating written or printed matter in any other way. Included in the type of information services that are subject to the tax are the services of furnishing credit information, building and construction information, advertising surveys, stock market analysis and advisory service information, and similar services. Persons who furnish taxable information services are not required to pay the sales tax upon their purchases of tangible personal property acquired for resale in the form of tangible personal property.

Information services do not include professional services nor services of employees or others who act in a representative or fiduciary capacity.

Where a contract for information services is entered into prior to July 1, 1952, requiring the rendition of such services commencing before that date and extending beyond it, the amount subject to tax is to be apportioned.

Article 78 of the Regulations to the extent it is inconsistent with the statutory enactment is deemed superseded by it.

In considering the taxability of information services, it may not be amiss to observe that the taxation of services under the sales tax law is not a novel development. From its inception the law has taxed services of a utility nature,⁴ and since 1942, "processing services".⁵

² P-H N. Y. TAX SERVICE, par. 77,556.

³ *Dun and Bradstreet, Inc. v. City of New York*, 276 N. Y. 198 (1937); *Booth v. City of New York*, 296 N. Y. 573 (1946); *Stampers Arrival of Buyers v. City of New York*, 296 N. Y. 574 (1946).

⁴ See Adm. Code, §N41-2.0, subd. a, par. 2.

⁵ See Adm. Code, §N41-2.0, subd. a, par. 5.

Processing Services

As just noted, the sales and use tax laws subject to tax the sale of processing or fabricating services performed upon another person's property not purchased by the latter for resale. Bulletin 1951-2 describes a type of transaction currently popular to which the processing provision is applicable.

With the improvement of television, owners of small-screen sets who purchased their receivers in earlier days are converting them to larger-size screens. The television service agency which does the conversion job furnishes the parts and materials essential to the conversion; in some instances, even a different cabinet may be required. The bill for the conversion job may be in a lump sum or there may be separate charges for labor and material.

Bulletin 1951-2 provides that, whichever method of billing is employed, the conversion of a small-size television set to a larger-size one constitutes a sale of taxable processing services, and the serviceman is required to charge and collect the tax upon the total receipts from the transaction. No tax is due from him upon his purchases of parts and materials which become a physical component part of the converted television set.

Change in Business Tax Rates and Dealers in Merchandise

Another of the several legislative amendments which became effective July 1, 1952 produced Bulletin 1952-10. As you are aware, the business (gross receipts) tax law imposes tax on: (1) financial business, and (2) other than financial business. For privilege periods ending June 30, 1952, financial business is taxed on the basis of gross income at the rate of $2/5$ of 1%, whereas general business is taxable upon the wider base of gross receipts at the lower rate of $1/5$ of 1%.

Bulletin 1952-10 points out that by virtue of a local law amendment, for privilege periods commencing with July

1, 1952, the rate of tax applicable to persons engaged in financial business is increased from $2/5$ of 1% to $4/5$ of 1%.

The bulletin also covers another amendment enacted this year, relating to dealers in merchandise. Preliminarily, you are aware that the term "financial business" as defined in the law⁶ includes (where the Comptroller shall determine as a fact, which determination of fact by the Comptroller shall be final) dealers in merchandise where the spread between the cost of goods sold and the sale price is analogous to or in the nature of a commission and does not exceed 3% of the cost of goods sold. This provision was apparently designed to prevent the hardship which would be occasioned by taxing the gross receipts of certain dealers in merchandise whose business is of such a nature that the margin of profit is extremely small. The dealers in this group are essentially wholesalers of perishable food commodities. The provision referred to has placed such dealers in the category of financial business, taxable on the narrower base of gross income, though at the higher rate of financial tax.

The other business tax amendment covered by Bulletin 1952-10 now affords relief to dealers in merchandise where the spread between the cost of goods sold and the sale price is analogous to or in the nature of a commission and is more than 3% but does not exceed 5%, where the Comptroller shall so determine as a fact, which determination shall be final. Dealers in this new classification continue to remain in the category of general business, but are taxable at the rate of $1/10$ of 1% of gross receipts, rather than at $1/5$ of 1% applicable to other persons in this category.

Dealers of merchandise in the new 3%-5% classification eligible for the reduced general business tax rate, like those in the 3%-or-less group, are generally wholesale dealers in perishable commodities.

⁶ Adm. Code, §B46-1.0, par. 2. See, also, Business Tax Regs., Art. 307

Change in Periods and Dates of Filing Returns of Sales and Use Taxes

Another legislative change deserving of notice is described in Bulletin 1952-8. Sales and compensating use tax returns are required to be filed within twenty days following the end of March, June, September and December.

This bulletin indicates that returns shall continue to be filed in this manner through the quarter ending March 31, 1953. Following that quarter, however, there is a short period of two months from April 1, 1953 through May 31, 1953, for which a return is required to be filed by June 20, 1953. Thereafter, the return periods revert to a quarterly basis and returns fall due within twenty days after the expiration of each quarter ending on the last days of August, November, February and May of each year.

This change in periods and due dates of returns does not apply to returns required to be filed on a basis other than a quarterly basis, as, for example, in the case of night clubs which are required to file on a monthly basis.

Models of Garments

A consistently recurring problem in sales tax law, productive of a number of judicial decisions⁷ as well as administrative rulings,⁸ relates to the term "retail sale".

The problem is again considered in Bulletin 1952-1. It appears that garment designers make up garments from designs created by them and sell those garments to manufacturers and others who use them as models. When the model garments have fulfilled their purpose, they are either sold for a nominal amount or given away as gifts. The bulletin holds that the sale of garments

by designers to manufacturers and others for use as models is a sale at retail upon which the sales tax should be collected by the designer. The manufacturer may not tender a resale certificate in lieu of payment of the tax. This result follows even though the manufacturer may later sell the model garments, because the garments when purchased by him are for use by him as models. If, after using the garments as models, he sells them to another for any purpose other than for resale, he will be required to charge and collect the sales tax from the latter because here, too, a sale at retail would take place under the terms of the local law.

Artwork and Photographs

Another chapter has been added to the long-standing controversy concerning the taxability under the sales tax law of commercial artwork and photographs furnished to magazine publishers and advertisers. Artwork and photographs are, of course, tangible personal property and, when sold or rented, are clearly subject to the tax. Article 70 of the Sales Tax Regulations⁹ provides, however, that a right to reproduce a painting, cover drawing, illustration or cartoon does not constitute a sale of tangible property and the consideration received is not taxable where delivery of the property is merely incidental to the right to reproduce and is not especially required for that purpose. The problem to be resolved, therefore, is whether there is a sale of tangible personal property or the grant of a right to reproduce in which transfer of possession is only incidental to the right to reproduce and is not especially required for that purpose.

The problem was first passed upon in 1938 in *Howitt v. Street and Smith Publications*,¹⁰ which was an action be-

⁷ E.g., *Matter of American Molasses Co. v. McGoldrick*, 281 N. Y. 269 (1939) (sales of containers to manufacturers and packers of products); *Matter of Mounting and Finishing Co. v. McGoldrick*, 294 N. Y. 104 (1945) (sale of cardboard and glue to a mounter of advertising displays).

⁸ E.g., Bulletin 1947-4 (furnishing and installation of oil burners).

⁹ P-H N. Y. TAX SERVICE, par. 77,540.

¹⁰ 276 N. Y. 345 (1938).

tween an artist and a magazine publisher based upon an agreed statement of facts, and to which the City was not a party. The court held, on the basis of the stipulated facts, that only a right to reproduce had been granted and since delivery of the paintings to the publisher's custody was not especially necessary for reproduction and the paintings were not defaced, consumed or exhibited, the transactions were not taxable.

Subsequently, in *Pagano v. City of New York*,¹¹ the transactions were held taxable upon a record which showed that the photographs and illustrations delivered by a photographer to his customers for reproduction in their publications were retouched, altered or cut and there was apparently no obligation to return them to the photographer.

The recently decided *Frissell* case¹² is the latest development in the field. That case involved a professional photographer who delivered photographic prints to a magazine publisher for reproduction in the latter's publications. The court found that the publisher had been granted only the right to reproduce the photographs and that transfer of possession was merely an incident of that right and not especially required for the exercise of the right. It found further that the publisher did not retouch the prints and regularly returned them intact to the photographer. In the circumstances the court held that there was not a taxable sale. The case was compared with the *Howitt* case, in which the paintings were not consumed or altered, and contrasted to the *Pagano* decision, where the prints were retouched, corrected or destroyed.

After the *Frissell* decision Bulletin 1950-2 was promulgated. This bulletin holds, as the cases above discussed seem to require, that the taxable status of transactions involving the furnishing of photographs, paintings, drawings and illustrations under a claimed right to reproduce depends upon the facts in

each case. A transaction is merely a right to reproduce and not taxable where delivery of the property is only an incident of the right to reproduce and is not especially required for that purpose, or where the property is in the temporary possession of the transferee for reproduction purposes and is not consumed, altered, retouched or destroyed or publicly exhibited by the transferee. On the other hand, a transaction is subject to tax as a sale of tangible personal property where title to the property is transferred, or where the property is publicly exhibited by the transferee, or where delivery of the property is necessary for the purpose of reproducing the same and is not merely incidental to the right to reproduce, or where the transferee consumes, alters, defaces, retouches or destroys the property or fails to return it to the transferor.

The facts to be adduced to support a claim of non-taxability will thus depend upon the special circumstances of each case. In this connection documentary evidence, such as the agreement of the parties and evidence concerning the regular and systematic conduct of the parties with respect to their transactions, should prove of assistance in resolving the problem.

Conclusion

I believe it may be fairly inferred from my remarks that although we may regularly seek new ways to facilitate the administration of our local tax laws, there is small likelihood that they can ever fall into a codified mold. Experience warns us that new problems will always crop up to keep our faculties keen, and that even today's decisions and rulings, which seem fairly definite and certain, may shortly require review. In taxation as in other fields we must always endeavor, consistently with the law, to adapt the rules to current needs.

¹¹ 295 N. Y. 784 (1946).

¹² *Matter of Frissell v. McGoldrick*, 300 N. Y. 370 (1950).

The Bureau of Excise Taxes—Today

By MORRIS W. WEINER

TAXES in one form or another have been with us beyond the memory of man, and, despite their age-old unpopularity, are relied upon as a principal source of revenue necessary for the functions of government whether it be on a national, state or local level.

In the City of New York the where-

withal to provide and maintain essential services is realized in a large measure from its excise taxes. These taxes encompass what are generally known as the Sales, Compensating Use, General Business, Utility, Conduit, Hotel Occupancy, Pari-Mutuel, Horse Race Admissions, Motor Vehical Use, Cigarette and Liquor license taxes.

For the last fiscal year ended June 30, 1952, collections from these sources exceeded a total of 315½ millions of dollars.

The City of New York does not possess inherent power to levy these imposts. It derives its authority solely by virtue of enabling acts enacted by the State Legislature and the subsequent action of the City Council by the enactment of Local Laws pursuant thereto.

The administration of these special taxes devolves by law and regulation upon the Comptroller, the Treasurer and the Corporation Counsel of the City of New York. To attempt to describe in detail the administrative role, the practice and established procedures of these important agencies would be impossible in the limited time at my disposal. However, before I embark upon the principal subject of my discussion, the work of the Bureau of Excise Taxes, it would be helpful to the taxpayer, the accountant and the lawyer to highlight briefly the entire excise tax administrative structure.

The taxpayer's first experience, relating to the administration of our excise taxes, is usually with the Division of Special Taxes of the City Collector's office under the jurisdiction of the Treasurer of the City of New York. I is with that office in the first instance that the taxpayer is required by law to register, file his returns and pay his taxes. For the taxpayer's convenience, and to facilitate and efficiently enforce his obligations, the City Treasurer

MORRIS W. WEINER, Esq., was appointed as Special Deputy Comptroller in charge of the Bureau of Excise Taxes on December 16, 1949. Prior thereto, Mr. Weiner was Chief of the Division of Penalties and Acting Corporation Counsel in the Office of the Corporation Counsel of the City of New York. He was appointed an Assistant Corporation Counsel in March of 1946 and served in the Division of Taxes, the Division of General Litigation and as Chief of the Division of Contracts and Transit Litigation. He was also a member of the Grievance Committee and Personnel Board by designation of the Corporation Counsel. Prior thereto, he was for many years on the staff of and served as Assistant to the Counsel to the County Clerk of Bronx County.

Mr. Weiner has been a member of the New York Bar for over seventeen years and has been admitted to practice in the United States Supreme Court. He is a member of the Philonomic Council, an honorary legal society, and has been active in numerous philanthropic, civic and fraternal organizations.

This paper was presented by Mr. Weiner at a technical meeting of the Society held at the Engineering Societies' Building on December 2, 1952, under the auspices of the Committee on Municipal and Local Taxation.

maintains divisional offices of the City Collector in all of the boroughs. Whenever a taxpayer is delinquent or defaults in the payment of taxes, the City Collector may enforce collection by filing a warrant which has the force and effect of a judgment.

In those situations where he is unable to locate any property of the taxpayer upon which a levy can be made to enforce the collection of taxes due, he will enlist the services of the Corporation Counsel who will thereupon initiate such legal proceedings as may be necessary in aid of collection. This includes garnishee proceedings, the service of orders upon third parties holding property of or are indebted to the delinquent taxpayer, and in instances of fraudulent conveyances by the taxpayer, the nullification of such transfers.

In the ordinary course of events, the taxpayer's next experience is with the Bureau of Excise Taxes which functions under the jurisdiction of the Comptroller, and is under the supervision and direction of the Special Deputy Comptroller in which capacity I serve. This arises by virtue of the Comptroller's obligation to perform audits, issue tax determinations, conduct hearings, and to promulgate rules and regulations.

Audits of taxpayers are initiated on the basis of a selective method of screening the tax returns filed. During the many years of the Bureau's existence, various methods were employed in the selection of returns for audit. Based upon the experience acquired, a more scientific approach to the problem was adopted whereby a code system was developed which has been in use since 1947. By this method, industries are broken down by types of business and are assigned designated code numbers. Persons engaged in the same line of endeavor are chronologically listed by registration number under the applicable code. On the basis of additional collated information, it can be ascertained at a glance which taxpayers have or have not been audited, as the case may be, and where audits have

been made, the periods covered thereby for each taxpayer, and the amounts realized under each code classification. Thus, where it appears that inadequate returns are being filed by particular industries, the resulting audits are not only productive in recovering additional taxes due, but serve to educate these taxpayers as to any misunderstanding they may have had with respect to the laws and regulations so as to insure the proper filing of future returns. The beneficial effect of the present plan permits of the selection of returns for audit upon the basis of sound rationale rather than upon random choice, and further brings about a greater rotation of taxpayer-audits.

Upon the selection of a case for audit, the taxpayer is notified in advance that a Bureau auditor will appear at his place of business on a given date to conduct an examination of his books and records. Experience has established that the institution of this procedure eliminated a source of taxpayer annoyance and irritation which had heretofore existed, when no advance notice was given, and results in a considerable saving of time both to the City and the taxpayer. Upon completion of the audit, if a deficiency in tax is found, the taxpayer may agree with the auditor's findings and sign a consent thereto which, after the issuance of a Consent Determination and payment of the amount found due, concludes the matter. At any stage during the course of audit, the taxpayer is free to confer with the auditor's Group Chief or Unit Head for proper consideration of his contentions. However, if the taxpayer is not in accord with the auditor's findings, a determination will be made which is subject to review as a matter of legal right by means of a statutory hearing, upon written request made therefor by the taxpayer within thirty days of the issuance of a Notice of Determination. Prior to the actual conduct of a formal hearing, the taxpayer is afforded a further opportunity to present informally before a hearing

conferee, competent proof in support of his position. In most instances, the issues in dispute are resolved at such conferences and the matter finally concluded by the execution of a consent by the taxpayer. If for any reason an agreement cannot be reached, the case is scheduled for a formal hearing which is similar to a trial conducted in the courts and is presided over by a formal hearing conferee. The taxpayer may be represented by an attorney or appear in his own behalf with his witnesses. An Assistant Corporation Counsel appears for and represents the City. Testimony is taken and a record of the proceedings made. Upon the conclusion of the hearing and after consideration of the record of the proceedings, a Final Determination issues to the taxpayer. The taxpayer's rights are not terminated by the Bureau's final disposition. He may seek a further review by applying to the courts as provided by law. It is pertinent to interject at this point that, before the issuance of any determination to a taxpayer, whether emanating from an audit section or the Hearings Unit, it is examined as to both accounting and legal aspects by the Reviews Unit and Tax Counsel in the Bureau.

The procedures which I have outlined relate generally to specific problems of individual taxpayers and constitute one important phase of the work performed by the Bureau of Excise Taxes. Equally important, because of the impact of policy decisions, is the function of issuing interpretive rulings and bulletins, and preparing regulations and amendments thereto. An efficient tax administration obviously demands more than just evolving technically sound procedures to govern the conduct of audits and hearings, which may be achieved by careful analysis and patient study of details. It comprehends, in addition, a knowledge and sympathetic understanding by both the tax administrator and the taxpayer of their mutual problems and difficulties to the end that unnecessary conflict and irritation may be eliminated. This is basic if effective administration and

sound public relations are to be fostered. Comptroller Lazarus Joseph, upon assuming his high office in 1946, recognized this principle and, under his stewardship, great impetus was given to this approach. I have strictly adhered to this policy. One factor, which has been effective in establishing better understanding between the Bureau and taxpayers, has been the practice of affording unlimited opportunity for a mutual exchange of ideas with respect to matters which arise from time to time. I should like to point out the satisfactory results that have been attained because of mutual cooperation. In 1951, the State Legislature authorized an increase in the sales tax rate from 2% to 3% which necessitated a revision of the bracket schedule then in force for the collection of the Sales Tax. The Sales Tax Law mandates the Comptroller to prescribe a schedule setting forth the amount of tax to be collected on each sale so as to avoid fractions of one cent and so that the aggregate collections of taxes shall approximate as closely as possible the statutory rate. The attainment of these objectives necessarily presents vexatious problems because of the varying price structures of retailers. As a preliminary step, the Bureau made field examinations of the records and sales transactions of thirty-seven representative types of retail enterprises. This survey covered approximately 25,000 separate sales transactions upon which the tax was computed under twenty-eight separate tentative bracket schedules. Upon the completion of this phase, the schedules were submitted to taxpayers, taxpayer groups and trade associations, representing a cross-section of the retail industry, for an expression of their views. They were invited to participate in the study and to attend conferences in the Bureau. After numerous discussions and additional tests, made by the interested parties, a schedule was evolved which was fair to both the consuming public and the vendor.

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In 1952, it became necessary to prepare and promulgate immediately regulations because of the enactment of three new taxes, namely, the Cigarette Tax, the Motor Vehicle Use Tax and the Retail Liquor License Tax. The impact of these new and diversified taxes created separate and distinct problems of administration. Despite the pressure of time, because of the short period existing between the enactment of the laws and their effective dates, the Bureau did not deviate from its policy of conferring with the various taxpaying groups affected by these laws. The manner in which the recent Cigarette Tax Regulations was evolved is another typical illustration of our approach to achieve fair and equitable administration, and to engender taxpayer cooperation. Since the State of New York had previously preempted this field of taxation, the collection of both a State and City tax by the vendors posed serious problems in administration. To eliminate possible areas of friction and conflict, the Bureau solicited and attended joint conferences with both the cigarette industry and representatives of the State. The intelligent interchange of thoughts resulted in the adoption of the Bureau's suggestion that a joint city and state cigarette tax stamp be used rather than separate stamps. This of course was a practical approach and has yielded economy in time, effort and expense to the taxpayer and in cost of administration to both the City and State. There were also presented numerous miscellaneous and subsidiary problems which were satisfactorily disposed of by joint effort. A similar approach in obtaining the views of those best qualified resulted in the issuance of satisfactory and workable regulations with respect to the Retail Liquor License and Motor

Vehicle Use Tax Regulations. Thus, it is evident that self-enlightened interests at work bring about the measure of cooperation so necessary to the efficient administration of tax law.

The Bureau in the immediate future will institute a revised procedure with respect to the issuance of tax deficiency assessments. Under the present practice, the assessment or Notice of Determination received by the taxpayer sets forth the amount of tax due for the fiscal periods under the several local laws. Although the field auditor apprises the taxpayer of the items which go to make up his assessment, I have found in many cases that the taxpayer and his representative, when first appearing for hearings on a protested assessment, are but vaguely familiar with its basis. This lack of understanding results in loss of time and effort which delays the expeditious closing of the matter. To improve this situation, assessments henceforth will be accompanied by a schedule which will clarify the issues by indicating the basis upon which additional tax liability is predicated. I have no doubt that this innovation will be welcomed by the accountants and attorneys appearing before the Bureau.

These salutary effects could not have been attained without the conscientious efforts of my tax counsel, my executive assistants and the auditing and clerical personnel of which Comptroller Joseph and I are duly appreciative.

On behalf of the Comptroller and myself I wish to thank the New York State Society of Certified Public Accountants and its Committee on Municipal and Local Taxation for extending this opportunity to me and members of my staff to join with you in what has been a most enjoyable evening.



Extensions of Auditing Procedure

By GORDON M. HILL, C.P.A. and ALVIN R. JENNINGS, C.P.A.

This paper provides an interpretive commentary on the subject of "Extensions of Auditing Procedures", which it is hoped will contribute materially to clearing up and clarifying the record with regard to the auditing standards of field work and reporting which are involved.

The January issue of this magazine included an article on Auditing Standards and the Extended Procedures—a Reexamination of Some Basic Concepts, by Benjamin Newman. Mr. Newman's scholarly and thought-provoking discussion merits the attention of all practicing accountants.

From time to time it has come to the attention of the Committee on Auditing Procedure that a number of auditing reports have been issued where the extended procedures specified by Auditing Statement No. 1 have not been applied even in circumstances where there

was a strong suggestion that the application of the extended procedures were both practicable and reasonable. In some such cases the auditors' reports contained no reference to the omitted procedures. In other cases the reports appeared to be deficient in that reliance has been stated to have been placed many times on "other procedures" in spite of the fact that the Committee on Auditing Procedure of the American Institute of Accountants has indicated that in its opinion cases where such reliance may properly be had are so rare as to be almost non-existent. Mr. Newman's article is timely and, with the interpretive comment which it is hoped that this communication will provide, should contribute materially to clearing up and clarifying the record with regard to the auditing standards of field work and reporting which are involved.

This contribution or follow-up to Mr. Newman's article is submitted because it is feared the emphasis was so placed by him as to result in further deficient reporting, although such was certainly not his intent. Also his discussion indicated that the original position or standard of procedure stated in Statement No. 1 had been modified to the extent it could be described as changed, when in the opinion of the Committee on Auditing Procedure it has merely been clarified. Mr. Newman develops at length his view that the position taken in the pamphlet, "Codification of Statements on Auditing Procedures" has the effect of changing certain of the previously established auditing standards of field work and reporting. This conclusion doubtless was based upon the admittedly unfortunate choice of language

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ALVIN R. JENNINGS, C.P.A., is a partner of Lybrand, Ross Bros. & Montgomery, C.P.A.'s. He is presently serving on the Society's Committees on Cooperation with Bankers and on Public Relations. He is also a member of the American Institute of Accountants and was chairman of its Committee on Auditing Procedure at the time the "Codification of Statements on Auditing Procedure" was issued.

in the Historical Preface to the pamphlet which, in discussing Auditing Statements Nos. 1, 3 and 12, stated that "changes in substance" had been made.

The Codification had not been long in print, before it became clear that the quoted phrase was susceptible of misunderstanding. The Committee, recognizing that the expression did not accurately convey its intent, in subsequent action changed the phrase so as to indicate that its purpose had been to clear up "ambiguities" contained in Statements Nos. 1, 3, and 12, and not to make changes of substance. Notification of the revision in language was accomplished through the medium of publication in Mr. Carman G. Blough's column "Current Accounting and Auditing Problems" in the August, 1952, *Journal of Accountancy*. As there stated, future printings of the codification pamphlet will contain the new language.

The important point which requires emphasis, is that it was not the intention (nor was it within the power) of the Committee on Auditing Procedure to modify any of the auditing standards, which had been adopted by vote of the membership of the American Institute of Accountants. The clarification it hoped to achieve had to do solely with the question of how the auditors' report should be drafted in those cases where inventory observation or confirmation of receivables, though practicable and reasonable, is not carried out but other procedures are employed which the accountant believes justify the expression of his opinion. It was the conviction of the Committee that Auditing Statements Nos. 1, 3 and 12 were not conclusively clear on how reports should be drafted in such circumstances.

Auditing Statement No. 1 contained the following observations relating to the auditors' report:

"The proposed changes will take time to bring about, and in the meantime the profession may well be faced with the necessity of submitting qualified reports in those cases in which it has been impracticable to carry out the added procedures." (page 7)

"In explanation of the general principles governing the auditor's opinion, with particular regard to explanations and exceptions, it is pertinent to state that the auditor satisfied himself as to the fairness of the statements 'by methods and to the extent he deems appropriate,' in general conformity with the auditing procedures recommended in the Institute's bulletin *Examination of Financial Statements*. Ordinarily, if he has so satisfied himself, he is in a position to express an unqualified opinion. However, if he considers it in the interest of clear disclosure of material fact to include explanations of procedures followed, he is free to do so. If, on the other hand, such disclosures are made by reason of any reservation or desire to qualify the opinion, they become exceptions and should be expressly stated as such in the opinion paragraph of the auditor's report." (page 10)

"It is desirable as a general rule that exceptions by the independent certified public accountant be included in a paragraph separate from all others in the report and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular item of the financial statement, the soundness of the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception." (page 11)

"If physical tests of inventories and/or confirmation of receivables are practicable and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear-cut exception in his report." (page 11)

These comments, perhaps understandably, left many practitioners with the question as to whether the exception should be reported in the "scope" paragraph of their reports or in the "opinion" paragraph or both.

Auditing Statement No. 3 had this to say with regard to this uncertainty:

"There appears to be a question in the minds of some concerning the character of exceptions necessitated by the omission of the added procedures when their application is practicable and reasonable. When the auditor has been unable to satisfy himself concerning the amount of inventories or receivables (or any other asset) stated in the accounts, he will continue, as in the

Extensions of Auditing Procedure

past, to make a definite exception as to the amount. Moreover, where the added procedures prescribed in 'Extensions of Auditing Procedure' are practicable and reasonable, if the auditor has not adopted them an exception is still required even though he may have satisfied himself by other means as to the fairness of the amount. What is the character of the exception in these circumstances?

"The report, 'Extensions of Auditing Procedure', clearly refers to several types of exceptions in the following language:

'Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular items in the financial statements, the soundness of the company's procedure (as regards either the books or the financial statements), or the consistency of accounting practices.'

"This leads to the obvious conclusion that when the added procedures are applicable and the auditor has not adopted them but has satisfied himself by other methods, his exception need cover only the omission of the procedures (affecting the scope of work), without calling into question the inherent fairness of the representations. On the other hand, were the auditor not satisfied, and were his exceptions so material or the scope of his examination so limited as to negate the expression of an opinion, he would limit his report to a statement of findings, and, if appropriate, say that the limitations, or exceptions, were such as to make it impossible to express an opinion concerning the fairness of the statements as a whole." (pages 19 and 20)

Had the comments in Statement No. 3 terminated at this point it would seem indisputable that the intention was that exceptions of the type here under consideration need be reported only in the "scope" paragraph. Some measure of doubt was cast upon this otherwise clear statement of position by the illustrative short form of report which was included in Statement No. 3, and which appears not only to include an exception in the portion of the report which deals with scope, but which also seems to make the opinion of the accountant subject to such exception.

Auditing Statement No. 12 primarily had relevancy to cases in which the amplification of the Procedures required by Auditing Statement No. 1 were not practicable and reasonable and, therefore, is not particularly germane to the present problem. Prior to the issuance

of Statement No. 12, in October, 1942, the position of record was that in such cases no disclosure of the omission of the required procedures was necessary. Since the Securities and Exchange Commission, on the contrary, had taken the position that disclosure was mandatory in all reports filed with the Commission, and since the difference in the two requirements gave the appearance of different standards as between listed and unlisted companies, the Committee on Auditing Procedures recommended that thereafter disclosure be required in the short form of independent accountants report or opinion, in all cases in which the extended procedures are not carried out, regardless of whether they are practicable and reasonable and even though the independent accountant may have satisfied himself by other methods. It is of interest and important to note that in stating its position on this question, the Committee at that time observed that it had become increasingly evident that relatively few cases exist in which the application of the procedures required by Auditing Statement No. 1 were not practicable and reasonable.

It was the opinion of the Committee on Auditing Procedures as it was constituted at the time when the Codification Pamphlet was in preparation, that the status of the record on this question as it then existed might be summarized as follows:

1. Relatively few cases would exist in which the application of the procedures required by Auditing Statement No. 1 were not practicable and reasonable but where the extended procedures specified by Auditing Statement No. 1 were not undertaken because it was unreasonable and impracticable to apply them, the "scope" paragraph of the auditors' report should state the omission. If the auditor had satisfied himself by other means, the "opinion" paragraph of his report did not require qualification.

2. Rarely (almost never) would cases exist where, although practicable and reasonable to apply the procedures required by Auditing Statement No. 1, the auditor had not followed such procedures but could and had satisfied himself by other procedures. Where such rare cases exist the omission

of the procedures should be disclosed in the "scope" paragraph but no qualification was necessary in the "opinion" paragraph.

3. In any case in which the procedures outlined in Statement No. 1 were not carried out and the accountant did not satisfy himself by other procedures, it was necessary to qualify the "opinion" paragraph or deny an opinion, whichever the reporting accountant thought appropriate in the light of the materiality of the inventories or receivables.

These conclusions seemed to the Committee to be the only logical interpretation of Auditing Statements Nos. 1, 3 and 12. As Mr. Newman pointed out in his article, the primary question of significance is whether the auditor in a given instance has satisfied himself as to the integrity of the representations of management as expressed in the financial statements.

To summarize, then, the Committee was not concerned with any question of circumstances which had a bearing on the determination of whether the application of the procedures specified by Auditing Statement No. 1 were practicable and reasonable (or impracticable and unreasonable) nor were its deliberations intended as a reexamination of the justification of the extended procedures. The Committee's interest was exclusively in clearing up ambiguities which had raised a question as to the appropriate wording of the "scope" paragraph in those instances where the auditor had satisfied himself by other means and had not employed the extended procedures even though it was practicable and reasonable to have done so. No matter how carefully its conclusions were phrased, it was apparent that a substantial risk would be involved that this conclusion might be misinterpreted as encouraging the omission of extended procedures even where practicable and reasonable of application. In an endeavor to guard against such misunderstanding, the Committee felt it necessary to reemphasize what had been said often before—that there would be relatively few cases in which it is not practicable and reasonable to follow the requirements of Extensions of Auditing Procedures. To accomplish

its purpose, in this regard, in discussing the matter in the codification pamphlet, the Committee purposely characterized situations in which the extended procedures were applicable but not applied as being "rare". Mr. Blough in his amplified remarks previously referred to, commented as follows:

"Mention should also be made of another point discussed at the committee meeting. Some accountants have asked, in effect, how infrequent is rare, as used on pages 8 and 21 of the codification. Those present at the meeting unanimously agreed that, where the term rare is used in the Codification, it means practically nonexistent. The committee's statement in the fourth paragraph on page 21 of the codification should, it seems to us, be interpreted as meaning that the committee believes it is seldom possible, in cases where inventory observation and confirmation of receivables are practicable and reasonable, to employ other procedures which will provide a satisfactory basis for expression of an opinion. However, it recognizes that there may be a few cases in which reliance on other procedures would be reasonable. Accordingly, it has used the word rare as a means of providing for those extremely infrequent instances in which other procedures may be satisfactory, and the accountant is willing to bear the burden of justifying their adequacy." (page 230) (The Journal of Accountancy).

This phase of the matter might well terminate with a repetition of a thought which has been expressed previously. It is the inescapable responsibility of each accountant to determine the scope of examination which he should make before giving his opinion on financial statements under review. In reaching this determination the examining accountant must necessarily give the most serious weight to the fact that the profession has adopted auditing standards which require the application of the extended procedures specified in Auditing Statement No. 1, whenever they are both practicable and reasonable of application. If, notwithstanding, the examining accountant concludes that he may omit such procedures from his examination and satisfy himself by other means, he must assume the burden of justifying his failure to conduct his examination in accordance with generally accepted standards.

Extensions of Auditing Procedure

Much of Mr. Newman's article deals with an emphasis on the importance of internal accounting evidence. He properly points out that the value of evidence of this type should not be minimized. It may well be that the contribution of the extended procedures to the reaching of a soundly based opinion, may in the course of time warrant re-examination and reappraisal. In the meantime the record seems clear that such procedures are a recognized part of the standards generally accepted as the basis for reaching an informed opinion, whenever it is both practicable and reasonable to apply them.

The technicalities of the discussion should not obscure the basic point that

with respect to the opinion paragraph of accountants reports only:

1. Any "qualification" required by generally accepted auditing standards before the issuance of the Codification, but after the date of the formal adoption of Statement No. 1—Extensions of Auditing Procedures, was also necessary after such issuance; and,
2. Where a "qualification" was not required by generally accepted auditing standards after the date of the formal adoption of Statement No. 1—Extensions of Auditing Procedures but before the issuance of the Codification, none was required after such issuance.



AN ADIRONDACK VIEW

Our Members are listed in a new directory which was born in April. Did you give it the once over—or only a quarter over? We turned-it-over to our Chapter's ABI, security agent, special investigator, and Un-New York Activities Committee. It was too late that day to start a new job, or go fishing, so HE went to work on it. Here is the report—which you can "evaluate" for yourself:

1. There are 78 azygous members. (Isn't that word a beauty!). They are not all upstate either, like Shay in Oneida, Leary in Massena, Whalen in Ogdensburg, Blake in Plattsburg, Guilmette in Canton, Oberst in Potsdam, and Leonard Ho (per Norman Webster) in Saranac Lake. They are scattered all over the state—some even in the Gotham Chapter.

2. And did you see what they did to Phyllis? And one of our women CPAs too! It was Un-American as well as Un-New York to treat her that way. And in practice under her own name too! Phyllis O'Hara sure got mistreated. They hung her name next after Louis Zwiefach, the last on the list of Brooklyn members. Even us 78 azygous members know that the letter O does not come next after Z in the alphabet—unless the Governor has recently signed some such new legislation, or a recent Tax Commission ruling is to that effect. Phyllis has her office in Bronxville—and desires to keep it there—if she didn't she would move it.

3. We are spread out into 161 different towns in the state. (Of course, CPAs are still thickest in New York City.) That is pretty good coverage. And some of the names and addresses are *not* exactly commonplace. The plastic gold medal goes to our azygous member Arthur Imholz, Skunks Misery Road, Syosset, L. I.

Well, see you at the Conference in June at Saranac Inn. Bring your replies, repartees, rejoinders and retorts—as usual. Hope a lot of azygous members will be there—when a CPA is the only one in his town, he needs to get out and see what other CPAs look like.

LEONARD HOUGHTON, CPA
Of the "Adirondack Chapter."

Procedures for the Audit of a Union Welfare Fund

By BERNARD HANDEL, C.P.A.

This paper describes the activities and auditing procedures of a labor union welfare fund. It is intended both to review suggested procedures for such an engagement and to acquaint practitioners with the functions of welfare funds. It also presents pro forma financial statements and discussion of accounting problems applicable to welfare funds, which are a comparatively new innovation in many industries.

ONE of the major developments of recent years in labor-management relations has been the steady trend toward awarding of so-called "fringe benefits" to employees. In certain cases, this trend has evolved from the realization of both workingmen and industry that "pocket" wages and social security insurance are not always adequate to provide security for the worker and his family against the ravages on savings of illness and death. Another condition encouraging this development has been the Government's wage stabilization regulations, which permitted the granting of fringe benefits at no reduction of allowable wage increases under its varied formulae.

These fringe benefits generally include one or more of the following type of benefits: life and accident insurance, hospitalization, surgical and medical protection, loss-of-time indemnity, etc. Government statistics indicate that over one-half of the working population of the country enjoy some form of hos-

pitalization and surgical insurance where a substantial portion of the cost is borne by the employers.

Another prominent type of fringe benefit is the retirement pension, where employers arrange for the payment of a certain amount to the employee after a predetermined retirement date, in addition to the employee's social security benefits.

In the nation's larger industries where area-wide or industry-wide unions are affected, the Welfare Fund Trust and Pension Fund Trust have arisen to handle the problems and mechanics of each respective form of employer-financed program.

In this paper we shall consider, for the sake of brevity and convenience, only the Welfare Fund Trust, since it is of a more general nature than the Pension Trust.

Though many practitioners have not had occasion to come into contact with union Welfare Funds, many of their industrial clients are presently (or may become) contributors to such a Fund. This article has been written with the dual purpose of reviewing audit procedures for such an engagement and to clarify the function and purposes of Welfare Funds, so that accountants may be assisted in answering the queries of their clients.

Formation of the Welfare Trust

The Welfare plan is generally established as a result of collective bargain-

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ing between the union and a group of larger employers in the area of that union. In the case of miners, the Welfare Fund was established by the main "international" office of the union on an industry-wide basis. In other instances, a particular union local may negotiate for a local Welfare Fund with its employers in a city or county (or the territorial area of the local).

After establishing the Fund through bargaining, the employers and union will each designate a certain number of its representatives as Trustees. Counsel would then draw up a Trust Agreement detailing the aims and intentions of the Trustees, and their functions and responsibilities. It should be noted that the law governing such trust arrangements insists that the books and records be available for inspection "to any interested persons", that such records be examined periodically by an independent accountant, and that the audit report similarly be available to interested persons.

The Trust and bargaining agreements will stipulate the manner of computing employer contributions (generally at a designated percentage of wages or certain number of cents per hour) and employee contributions, if any. It has been the practice of most Welfare Funds to accumulate funds for a period of time prior to issuing any benefits, in order to build up a working surplus.

The benefits provided to union members in good standing under the general type of Welfare Trust include life, accidental death and dismemberment, hospitalization and surgical insurance. Many funds also provide some form of loss-of-time indemnity for non-occupational accident or illness. (In New York State, this coverage is usually at least of an amount and duration which is equivalent to the State Disability Benefits Law.)

Most Funds provide these benefits by a group contract with an insurance company. Certain large Funds (such as the Coal Miners and Garment

Workers) have become self-insurers. Since the average auditor will more frequently come into contact with the "insurance policy" type of plan, we will not in this paper discuss the self-insured plan, although its basic accounting problems are similar (with the obvious exception of providing for actuarial reserves and test-examination of individual claims paid).

Incidentally, it might be worthwhile to point out that when an accountant notes that a client is paying into a Welfare Fund providing New York State disability benefits coverage, he should ascertain that the client is not making a duplicate payment on its private disability insurance policy.

Commencement of Engagement

Prior to beginning his examination of a Welfare Fund, the auditor should ascertain that he has been officially engaged by the Trustees, since they are the only persons generally authorized under the Trust Agreement to make such choice.

In this type of examination, the accountant will probably deal mainly with the administrator and his staff. However, his responsibility is to the Trustees, the many contributing employers and the union members. This engagement requires an extremely impartial and intelligent approach to the development of audit procedures.

The first step should be the accumulation of the various documents establishing the Fund. The auditor should read and excerpt (or obtain a copy of) the collective bargaining and Trust agreements. He should, in passing, satisfy himself that the plan was accepted by the Internal Revenue Bureau and Wage Stabilization Board; when the plan provides New York State disability benefits, it must also be approved by the Workmen's Compensation Board.

After thoroughly familiarizing himself with the legal status and functions of the Fund, the auditor should then

turn to the most important part of his examination, the review of the system of internal control.

Review of Internal Control

The main form of income to a Welfare Fund will be the contributions of the employers and employees. Its prime expenses will be for insurance benefits and administrative expenses and services.

The auditor should ascertain that proper control is exerted over income reasonably to insure that such receipts are promptly deposited intact in the bank and that proper records are kept thereof. As discussed later in this paper, he should correspond with employers to verify such contributions. The auditor should test the computation of employer payments and determine whether proper safeguards are taken by the administrative staff to prevent errors therein.

In connection with disbursements, the Trust Agreement will generally stipulate that major disbursements be by check and that each check be countersigned by a designated employer-Trustee and union-Trustee. The Agreement will also restrict the type of disbursements to be made and require that payments be approved by the Trustees. The auditor should verify that the major disbursements were authorized in the minutes of the Trustees and that such expenses were substantiated by proper vouchers.

Where the plan is operated through an insurance contract, it would not appear mandatory to this writer that the auditor check in detail the eligibility records of members insured or insurance costs other than to satisfy himself that proper internal methods are employed in relation to eligibility record-keeping. However, the auditor should, of course, examine the master policies, test the insurance computation (though not necessarily the number of employees reported) and correspond with the insurance carrier as to the existence

of the policy, premiums paid, unpaid premiums, contingent liability and return premiums due.

Other Audit Procedures

In addition to the usual procedures employed for the verification of balance sheet items (cash, investments, prepaid insurance premiums, fixtures and other assets, premiums payable, other liabilities, etc.) by direct correspondence, vouching or inspection, the auditor should satisfy himself as to the general accuracy of income received.

In this connection, he should first review the system of internal control as previously discussed. Subsequently, he should confirm by direct correspondence with contributing employers the amount of income reflected by the books. This confirmation should generally be of a test nature, encompassing employer's reports for a period of from three to five months. In certain instances, the employer-Trustees have desired the complete verification of an entire year's receipts, which, of course, should be noted when fee arrangements are consummated.

In their verification requests, some accounting firms have asked employers to advise them of total contributions for the stipulated period. Based on the experience of this writer, the auditor will achieve a higher percentage of replies if he lists, in the letter, each period reported and the amount of the employer contributions indicated by the Welfare Fund's books, requesting the companies to verify the accuracy of the amounts and to indicate the date of payment of such contributions. This procedure will also tend to eliminate much subsequent correspondence and confusion, particularly since Welfare Funds' income records are generally maintained on a cash basis, which may conflict with either accrual basis accounting or varying fiscal years of the employers.

Where employees pay a portion of the Welfare contributions, such pay-

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ments will generally be treated as payroll deductions and forwarded by employers to the Fund. Verification procedures would then be identical to those applicable to employer contributions.

The audit procedures relating to insurance premiums and other expense have been mentioned in a prior paragraph. In this connection, the writer urges the forwarding of letters at least to a cross-section of the vendors and suppliers with whom the Fund had transactions during the period under review, requesting statements of their account at the balance sheet date.

The auditor should excerpt (or preferably obtain copies of) the minutes of the Trustees' meetings and satisfy himself that their resolutions are reflected,

where applicable, in the financial statements. Where a disbursement approved by the Trustees does not appear to be stipulated in the Trust Agreement, the auditor should obtain an interpretation from the Fund's counsel and, if necessary, make full disclosure of such fact in his report.

The auditor should also correspond with the Fund's legal and insurance consultants and actuaries relating to contingent liabilities, lawsuits, unpaid fees, etc.

Financial Statements

The statement of assets and liabilities of a Welfare Fund operating through insurance contracts should appear approximately as follows:

ASSETS		LIABILITIES	
Cash in bank	\$xxx	Accounts payable and accrued expenses	\$xxx
Investments at cost (market —\$xxx)	xxx	Insurance premiums payable.	xxx
Prepaid insurance premiums	xxx	Other liabilities	xxx
Estimated insurance return premiums (dividends) ...	xxx	Total	\$xxx
Fixtures and other assets ...	xxx	Unexpended employer contributions	xxx
Total	\$xxx	Total	\$xxx

Since the Fund has no method of accurately determining the amount of employer contributions until they are reported and paid, income records of Welfare Funds are usually maintained on a cash basis. The balance sheet should be footnoted to indicate that unpaid employer payments applicable to periods prior to the balance sheet date are not reflected. If such payments can be estimated on the basis of subsequent collections, an approximate figure may be inserted in the footnote.

A similar footnote may be required where insurance dividends or retention return premiums are indeterminable at the balance sheet date.

Where the Welfare Fund has assumed the New York State disability benefits coverage for its members, it will also generally have assumed the liability to meet assessments for additional contributions to the State fund that may be levied under the Mailer-Condon act. A footnote to that effect should also be reflected on the financial statements.

In passing, it might be well to point out that many large industrial corporations are also subject to this Mailer-Condon assessment under the New York State Disability Benefits Law, especially where they are self-insurers. This writer does not recall having seen

such a footnote on the financial statements of any such corporation. In view of the favorable claim experience of the State, however, such an assessment will probably not be too material, although its eventuality is fairly certain.

Where employees contribute to the plan and such payments are returnable upon the happening of certain events, the unexpended portion should be indicated separately on the balance sheet and disclosure made of the possible liability for repayment.

The financial statements should also contain footnotes relating to special contingencies such as lawsuits, etc., if required.

The "income" statement would usually appear as follows:

Employer contributions	<u>\$xxx</u>
Expenses:	
Insurance premiums (net) .	\$xxx
Administrative expenses ..	xxx
Other expenses	xxx
Total expenses	<u>\$xxx</u>
Excess of contributions over expenses (to unexpended contributions)	\$xxx
Unexpended employer contributions — end of previous period	<u>xxx</u>
Unexpended employer contributions — at balance sheet date	<u>\$xxx</u>

Where employee contributions are made and no repayment is provided for in the Trust Agreement, they should be included as a separate caption in the income statement.

In the case of the self-insured welfare fund, other problems will arise, mainly applicable to the expenditure of funds for claim payments and to the establishment of actuarial reserves. Considerable literature has been written in connection with the problem of self-insurers which would be of assistance in the event of such an audit engagement.

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New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Change of Classification—Real Estate and Business Corporation

Generally a real estate corporation taxable under Article 9 enjoys a privileged status in relation to the business corporation. The franchise tax for the real estate corporation is one-fourth of a mill on the value of its gross assets, if there has been no distribution of any dividend, as compared with say 5½% of entire net income for the business corporation taxable under Article 9A.

The additional tax of 2% on dividends paid can make the real estate status a bit hazardous. This is due to the fact that the term "dividend" has been given a rather broad scope. It includes, for example, the distribution of the entire earned surplus upon dissolution. Furthermore, earned surplus includes any surplus resulting from any appreciated value in property distributed upon dissolution.

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Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

To enjoy the privileged status of a real estate corporation the corporation must be wholly engaged in the real estate activities enumerated in Section 182 or lose its classification as a real estate company. The law permits the real estate company to own stocks, bonds or other securities provided such holdings do not exceed 10% of average gross assets. If such holdings exceed the 10%, the real estate company loses its classification as a real estate corporation and becomes taxable as a business corporation. Upon a change in classification the corporation becomes subject to the 2% tax on its surplus.

It is important to know just when a change in classification occurs, particularly if the holdings of a corporation keep changing during the year. Does its classification keep changing back and forth as its holdings change?

Article 160 of the 9A regulations has something to say on this point. The first paragraph makes the statement that by reason of a change in the nature of its activities a 9A corporation may cease to be subject to tax under Article 9A and become taxable under some other article, the converse also being true. "The date on which any such change of classification becomes effective will be determined by the facts of each case." The same regulation states that a real estate corporation becomes subject to tax under Article 9A *on the first day of the following year* if more than 10% of its average gross assets is invested in securities. Furthermore, if in a later year 10% or less of the average gross assets is invested in securities, it again becomes subject to tax under Section 182 on the first day of the following year.

There is a different rule if the change in classification is due to the fact that the same interests own or control a business corporation and a real estate corporation and the business corporation uses a material part of the real property of the real estate corporation. In such a case the real estate corporation *immediately* ceases to be taxable under Article 182 and immediately becomes subject to tax under Article 9A.

The Regulations illustrate the above rules by examples. In the first example a 9A corporation which operated a hotel leased it to an operating company on April 15, 1946. The corporation had no other assets or business. The corporation ceased to be subject to tax as a 9A corporation on April 15, 1946. It would file as a business corporation for the period from January 1, 1946, to April 15, 1946. Its first franchise tax under Article 9 would be due on March 1, 1947.

If the corporation resumed possession of the hotel and commenced to operate it again on June 1, 1947, it would again become subject to tax under Article 9A on June 1, 1947. Under a 1950 amendment to Section 182.1, the franchise tax paid on March 1, 1947, as a real estate corporation would be prorated and the corporation would be entitled to a refund of one-half the tax paid on March 1, 1947. Under a 1947 amendment to Section 182, on a change in classification earned surplus of a corporation formerly taxable under Article 9A is excluded in computing any additional tax under that section (the 2% tax on dividends). In our opinion the 2% tax would not apply on the second reclassification to that portion of the earned surplus which the corporation had when it was classified as a real estate corporation on April 15, 1946. It would again file as a business corporation for the period from June 1, 1947, to December 31, 1947.

The third example is one of a corporation that owned two parcels of

property. It sold one of them on April 1, 1946, and immediately invested the proceeds in municipal bonds. Since more than 10% of the average gross assets for the year 1946 consisted of securities the corporation loses its classification as a real estate company and becomes subject to tax under Article 9A on January 1, 1947.

If during the year 1947 the corporation sells the securities and purchases another parcel of real property and, on the basis of the average gross assets for the year, the holdings in securities were less than 10% of the average gross assets including the securities, the corporation ceases to be taxed under Article 9A and becomes subject to tax under Section 182 on January 1, 1948.

Dividends

A dividend is taxable income to the stockholder. Section 359 of the Income Tax Law defines it as "any distribution made by a corporation out of its earnings or profits to its shareholders or members, whether in cash or in property or in stock of the corporation, other than stock dividends." If a corporation has a deficit and no earnings or profits, a distribution in the accounting and legal sense is a return of capital. Under the federal law a distribution is nevertheless taxable as a dividend to the extent of current year's profits even though the corporation has an overall deficit. Although the state law has no similar provision the Attorney General issued an opinion in 1937 holding that a distribution from current earnings is a taxable dividend, even though paid when the capital of the corporation was impaired. This ruling has been followed in one court case.¹ In our opinion there is no sanction for this in the Income Tax Law or Regulations.

Dividends are income for the year in which payable. On the accrual basis that would be the record date as of which

¹ *People ex rel. Cowan v. Graves* (1940); 258 App. Div. 699, affd. 284 N.Y. 628.

the stockholder becomes entitled to the dividend. On the cash basis the taxpayer is in constructive receipt of the dividend on the date on which it is payable. However, if the corporation customarily mailed dividend checks on December 31, and in the regular course of the mail the check is not received until January of the following year the dividend is taxable in the following year. The federal rule is different. Both for accrual and cash basis taxpayers the dividend is not taxable until the year it is received.

A stock dividend, that is a dividend paid in stock of the company declaring the dividend, is not subject to tax. The law itself (Section 350.8) defines a stock dividend as "new stock issued for surplus or profits capitalized to shareholders in proportion to their previous holdings." Article 64 of the Regulations provides that dividends paid in stock which has once been issued and subsequently reacquired are taxable. The inclusion of a dividend paid in treasury stock has received the sanction of the court.²

Until a recent Tax Court decision,³ the federal rule was thought to be different. Now there may be some doubt. Because of the importance of the decision the *Schmitt* case is now being reconsidered by the entire court. If the stock dividend gives the stockholder an interest in the corporation different from what he had before he is in receipt of taxable income. Under state law all stock dividends are non-taxable. There is a provision in the law (Section 359.2m) that may make a stock dividend taxable. If before or after the distribution of a stock dividend the corporation "proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend", the

amount received becomes a taxable dividend.

Under the federal law a regulated investment company may allocate distributions between ordinary income and capital gains and the distribution will be taxed to the stockholders in accordance with this allocation. There is no similar provision under state law and all distributions from regulated investment companies are taxed as ordinary income.

Interstate Commerce and Taxation

In Report Bulletin 17⁴ of the New York Tax Service, Prentice-Hall comments on the Supreme Court cases that have dealt with the taxation of interstate commerce in the past thirty years under the caption, "Milestones in Interstate Commerce." This is supplemented by a chart of the principal cases together with the Court's decision, the type of tax involved, etc. Prentice-Hall notes that the over-all trend is toward an enlargement of the power of states to tax interstate commerce. Lawyers and accountants will want to read the report and get the chart.

The subject merits some further comment. The Constitution of the United States gives Congress the power to regulate commerce among the states⁵ and this power has been construed as preventing a state from imposing a tax that would constitute a restriction or burden on interstate commerce. Of course every tax is a burden, but since a state does have the power to tax property within its jurisdiction on business carried on within its geographical boundaries even though the property or business is part of a larger business interstate in character, the question becomes one of determining whether the burden is an unnecessary one or one that discriminates unduly against interstate commerce. It is a question of degree.

² *People ex rel. Clark v. Gilchrist* (1925); 214 App. Div. 117.

³ *Joseph P. Schmitt*, 19 T.C., No. 114, March 9, 1953.

⁴ March 2, 1953.

⁵ Article I, Section 8.

Maintaining an Office for Soliciting Orders

The first case on the Prentice-Hall chart is *Cheney Bros. Co. v. Mass.*,⁶ decided in 1918. The corporation was organized in Connecticut and maintained a selling office in Boston. Five salesmen were attached to the office; four of them traveled through New England. Orders were subject to approval by the home office in Connecticut and shipments were made directly to purchasers from Connecticut. No stock of goods was kept in Boston, only samples used in taking orders. The Court held the Massachusetts tax invalid as one on doing an interstate business. The tax is referred to as an excise tax, but it was based upon allocated corporate income.

The Prentice-Hall chart does not go beyond the year 1940 so that it does not include the case of *West Publishing Co. v. McColgan*,⁷ where the Court upheld a California net income tax on a foreign corporation which maintained salesmen in the state who solicited orders for acceptance in and shipment from Minnesota. The salesmen received payments on orders taken by them, collected delinquent accounts and made adjustments in cases of complaints. The Court sustained the tax as an income tax although a franchise tax on the privilege of engaging in the business carried on would have been in violation of the interstate commerce clause. The U. S. Supreme Court affirmed the decision.⁸

Article 141 of the Regulations under Article 9A provides that the solicitation of orders through traveling salesmen or a sales office does not constitute the taxable doing of business if that is the corporation's only activity in New York. The Regulation further provides that the orders must be forwarded

to the home office outside the state for acceptance and the merchandise must be shipped from a point outside the state. New York considers the activities in New York as being part of interstate commerce. If the foreign corporation maintained a stock of goods in New York and filled the orders from its New York stock, the corporation would be subject to the New York franchise tax (Example 2, Article 141).

Interstate Commerce—Allocation

If a foreign corporation is doing business in New York and is subject to tax under the income basis, New York may take into account the entire net income of the corporation, including interstate income, provided it subjects to tax only the portion allocated to New York under an allocation formula. Such a formula was sustained in *Underwood Typewriter Co. v. Chamberlain*⁹ and in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*.¹⁰ In the latter case, an English Company maintained offices in Chicago and New York. While the business as a whole operated at a profit, the federal income tax return showed a loss from United States business and the corporation paid no tax. Nevertheless in accordance with the New York allocation formula a portion of the total net income of the business was assigned to New York and the Supreme Court held that the franchise tax based upon entire net income was not a prohibited burden on foreign commerce.

Liquidation Under Section 354(9)

The 1952 Legislature added subdivision 9 to Section 354. This provision permitted the distribution of property in complete liquidation of a corporation without the immediate recognition of gain. The provision is similar to Section 112(b)(7) of the Internal Rev-

⁶ 246 U. S. 147.

⁷ 27 Calif. 2d, 705, 166 P. (2d) 861 (1946).

⁸ 328 U.S. 823 (1946).

⁹ 254 U.S. 113 (1920).

¹⁰ 266 U.S. 271 (1924).

enue Code. The law was effective in the case of complete liquidations of corporations occurring within one calendar month in 1951 or 1952.

The Tax Commission recently issued a ruling¹¹ on the question of whether a corporation must actually be dissolved in order to meet the requirements of a complete liquidation under Section 354(9). The Regulation (Article 493(i), sub. 21) is silent on the specific question. It does say that "it is not necessary that the corporation dissolve in the month of liquidation, it is essential that a status of liquidation exist at the time the first distribuion is made. . . . A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts and distributing any remaining balance to its shareholders."

Deputy Commissioner Kassell says that by implication the Regulation requires the dissolution of the corporation to effect a complete liquidation within the meaning of the statute. Neither the

statute nor the Regulation contains a time limitation for such dissolution. Commissioner Kassell notes that the Regulations under the Internal Revenue Code (Section 29.115-9) provide that a dissolution within one year after a distribution in liquidation satisfies the statutory requirement of complete liquidation and removes any question of such distribution being a taxable dividend. Commissioner Kassell adds that such a statutory construction does not appear to be unreasonable. He therefore concludes that there can be no complete liquidation of a corporation within the meaning and intent of Section 354(9) unless there is a dissolution of the corporation within one year after the liquidation.

The Commissioner was also asked to rule on the effect of a reacquisition by the corporation of property subsequent to a liquidation. To this Commissioner Kassell says that such a reacquisition results in a failure to meet the requirement of complete liquidation.

¹¹ February 25, 1953.



MORE ABOUT AN INCORPORATOR

One of the important—yes and pleasant—results of publishing historical articles is that so frequently they bring to light other incidents of which the authors had never heard. The story of The Incorporators of the New York State Society of CPA's in the March, 1953, issue of this magazine had just such an outcome.

Before noon of the day when that issue of the magazine was delivered by the postmen, this Committee's attention was directed to a novel incident—one which had never occurred previously and which could not happen again.

At the Annual Meeting of the Society on May 13, 1946, President Donaldson read a scroll which the Directors had prepared for Farquhar J. MacRae the only living charter member of the Society. The scroll was inscribed as follows: "The Board of Directors of The New York State Society of Certified Public Accountants in the fiftieth year of the Society, awards this Charter Member Certificate to Farquhar J. MacRae, a charter member in recognition of his loyal and continuous membership since the founding of the Society in 1897 and his many contributions to the development of its activities."

—THE COMMITTEE ON HISTORY.

Accounting at the S. E. C.

Conducted by LOUIS H. RAPPAPORT, C.P.A.

The 18th annual report of the Securities and Exchange Commission was recently published. It covers the fiscal year ended June 30, 1952. Like "Omnibus" on television, the report has something for everybody. There is a lot in it which will interest people generally. This article will tell about those items in the report which will interest accountants particularly.

Independence of Accountants

Most accountants appreciate the necessity of preserving their independence and scrupulously avoid having financial interests in or relationships with their clients which would in any way create doubt as to their independence as accountants. The rules of professional conduct contain provisions designed to prevent an accountant from holding himself out as independent when, in fact, he is not. Despite all that has been written and said on the subject, no year goes by but what some accountant stubs his toe at the SEC—frequently in the most obvious way. This is one aspect of the practice of accountancy that the SEC has helped to sharpen and define.

The latest annual report of the SEC points out that in a number of cases evidence developed by its staff indicated that the financial statements included in registration statements filed with that agency had been certified by accountants who, under the rules of the Commission, could not be considered

independent of the registrant. One of these registrants was a new investment company whose certifying accountant was also its treasurer, a director and a stockholder. Any one of these relationships would have been enough to disqualify the accountant from certifying for SEC purposes.

Two other cases were cited by the SEC in which the accountants were deemed not to comply with the Commission's standards of independence. The cases were similar in that the disqualifying relationships were not discovered until shortly before the registrations were to have become effective. In both cases the accountants had served the clients for many years and during the period for which they certified financial statements included in the registration, they had participated in real estate transactions with officers of the registrants under circumstances which led to the conclusion that the accountants could not be considered independent of the registrants. In both cases new accountants were appointed, but there resulted delays and expenses which could have been avoided.

Events Subsequent to the Balance Sheet Date

This remains one of the most provocative fields in all accounting literature. The SEC in its current annual report makes a significant contribution. The Commission reports the case of a company in the liquor business which filed an annual report with the SEC under the 1934 Act. A note to the balance sheet disclosed that, within the month subsequent to the balance sheet date, settlement in a substantial amount had been made in respect of claims against the company relating to its sale several years previously of investments

LOUIS H. RAPPAPORT, C.P.A., has been a member of the Society since 1933. He is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.'s.

in certain companies. The accountant's opinion covering the financial statements was signed approximately seven weeks after the settlement date.

The SEC requested and obtained the filing of revised financial statements reflecting the settlement *and based its request on the fact that the accountants had knowledge of the final status of the claims when they signed their opinion.*

Property Acquired for Stock

One of the cases discussed by the SEC in its annual report dealt with the accounting followed by a company that applied for listing of its shares for trading on an exchange. The company had issued certain of its no par value shares for property and reflected the property in the financial statements on the basis of an arbitrary value of 50 cents for each of the shares issued. Concurrently shares of the same issue had been sold to yield the company 10 and 15 cents a share. Subsequently the shares were converted into one-quarter of their number with a par value of 10 cents a share. In order to eliminate the overstatement in the property account arising from the use of the arbitrary (50 cents per share) value, the capital surplus applicable to the shares issued for property, which resulted from the conversion, was required to be applied in part to reduce the property accounts to values comparable to the consideration received for shares sold for cash.

Depreciation Based on Replacement Cost

During the year covered by the present report the SEC states that it had to reconsider in the light of existing conditions many of the problems which developed during World War II. "For example," says the Commission, "there was renewed advocacy—not concurred in to any large extent by accountants and corporate officials generally—for the application of the theory that depreciation of fixed assets is re-

lated directly to replacement and that provisions from income for depreciation are inadequate unless they will provide for the replacement of the applicable assets at the time they are retired from service. Some holders of this view would, in effect, abandon historical costs completely by adjusting such costs, in financial statements, to reflect changes in the purchasing power of the dollar".

The Commission had previously stated that it would continue to require adherence to historical costs in statements filed with it. The SEC now says that it has found no justification for changing its requirements in this respect.

Business Combinations; Purchase vs. Pooling

One of the accounting research bulletins (No. 40) of the AIA deals with the subject of business combinations and sets forth certain criteria under which a combination may be considered to be a purchase or a pooling of interests. The importance of the distinction lies in the fact that in a purchase the assets purchased should be recorded on the books of the acquiring company at cost irrespective of the amounts at which they are carried on the books of the selling company; in a pooling the necessity for a new basis of accountability does not arise and earned surplus of the constituent companies may be carried forward.

In its 18th annual report the SEC discusses a case in which the distinction between a purchase and a pooling was important. It arose in connection with the filing of preliminary proxy soliciting material submitted by a food manufacturing company with total assets of \$95,000,000. The material filed with the SEC included a pro forma balance sheet giving effect to the acquisition of the net assets of a company with total assets of \$15,000,000.

The registrant issued 115,000 shares of its common stock, \$25 par value per

share, for the net assets of the company *to be acquired*. This represented the issuance of approximately 20% additional stock. The sum of \$2,296,000, representing the excess of the common stock equity of the company to be acquired over the par value of the registrant's stock, was reflected in the pro forma balance sheet in earned surplus. Since the transaction was represented as a purchase, and it so appeared to the Commission, the SEC required the aforementioned credit to be made to capital surplus rather than earned surplus.

In its discussion of this case, the SEC stops there. The case, it seems to us, leaves unanswered certain questions: if this was deemed to be a purchase, what was the justification for recording the assets acquired at the amounts at which they appeared in the accounts of the selling company, or did this, in effect, represent cost to the purchaser? What was the fair value of the stock issued for net assets? These are matters which are, in our view, more important than the carry-forward of earned surplus.

In another case there was a filing of a registration statement under the 1933 Act, in which the SEC also had to consider the matter of business combinations. In this case the registrant was organized for the purpose of joining a number of companies engaged in the oil business. The registrant stated that the transaction was a purchase (as distinguished from a pooling) and that the assets of all the companies should be stated on the basis of an amount, agreed upon by the constituents, representing the value of the shares issued. On this basis the balance sheet would have shown total assets of \$14,500,000 and capital surplus of \$10,000,000.

The Commission states that giving consideration to the nature and effect of the transactions resulting in the formation of the registrant and its absorption of the businesses of its predecessor and subsidiary companies, it concluded that the transaction in substance in-

involved a pooling of interests. As a result the balance sheet of the registrant reported total assets of \$8,400,000 and capital surplus of \$4,100,000. What the Commission does not say is what were the circumstances which led it to conclude that this case involved a pooling rather than a purchase.

Treatment of Arrearages in Reorganization

A manufacturing company filed preliminary proxy soliciting material to be used in connection with a meeting of stockholders at which it was proposed to effect a plan of recapitalization in order to eliminate accumulated and unpaid dividends of \$8,600,000 on the preferred stock. The proposed recapitalization was to be effectuated through a statutory merger of the company with its wholly-owned subsidiary.

The plan contemplated the issuance by the surviving parent company of debentures and new common stock primarily to the holders of the preferred in exchange for their preferred shares and in satisfaction of the unpaid dividends on this stock. A pro forma balance sheet included in the preliminary proxy statement gave effect to the proposed recapitalization. In this balance sheet earned surplus of the parent company in amount of \$578,000 was brought forward in the merger as earned surplus of the surviving company rather than as capital surplus.

As is usual in cases of this kind, the Commission wrote the company a letter in which it pointed out that the dividend arrearages far exceeded the earned surplus. In view of this fact the SEC said earned surplus should be brought forward in the merger as capital surplus, and that after the merger, accumulated earned surplus should be dated from the date of reorganization. As a result the pro forma balance sheet in the final proxy statement was changed to reflect the earned surplus of the company as capital surplus after the merger.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Unemployment Insurance Contribution Rates

The New York State Experience Rating Notices mailed to employers recently, assigned the contribution rate to be used when reporting contributions due on the quarterly reports due on April 30, July 31, October 31, 1953, and January 31, 1954.

The notice indicates that the size of fund index as of July 1, 1952, was 9.2 per cent. That index means that individual employer rates can range from 0.7% up to 2.7% for the year 1953 depending upon the individual employers experience factor. Employers whose experience factors totalled 6 or less, or were of insufficient age, or were delinquent for payments to the fund, were assigned 2.7% rates. Other employers were granted reduced rates. On a million dollar annual payroll a reduction in rate of 0.1 per cent could mean a saving of \$1,000.00 in contributions payable by the employer. It is advisable therefore that the accountant examine the Experience Rating Notice received by his client for the purpose of checking on the rate assigned to the employer.

Each of the four factors used in de-

termining the individual employer's class should be checked. These factors are:

1. The "*Benefit*" factor which carries the most weight in determining the employer contribution rate. The benefit factor value ranges from "0" to 16 points depending upon the amount percentagewise of the employer's account benefit experience;

2. The "*Quarterly*" factor, determined by taking the sum of the percentage decreases in remuneration (all earnings, including amounts paid to individual employees in excess of \$3,000 during the calendar year) paid from one quarter to the next for the 12 quarters of the 3 consecutive years prior to July 1st, 1952. This factor is worth from zero to 2 points depending upon the sum of the quarterly decrease quotients. It is important in this regard to allocate bonus payments equally over the four calendar quarters rather than to charge the entire amount of the bonus to one quarter, which in most cases is the fourth quarter of the year. The effect of charging the bonus payment to the fourth quarter rather than spreading it out among the four calendar quarters of the year is to create a percentage decline from the fourth quarter of the year to the first quarter of the following year with an adverse result in the employer's experience rate.

3. The "*Annual*" factor, consisting of the "0" to 2 points granted if the sum of the annual percentage decreases in taxable wages from the first to the second and the second to the third of the 3 consecutive calendar years immediately preceding July 1st, 1952, falls within the sum of certain percentage decreases set forth in the law granting

(Continued on page 357)

SAMUEL S. RESS has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Tax Season Post Mortem

Now is time to review the performance of your tax department procedures during the personal income tax period just closed. Record, for consideration prior to next year's tax period, the failures and weaknesses that were recognized and what can be done to avoid them. List the improvements that you recognize are possible. Do not trust to your memory. This policy, each year, will make possible a steady improvement in the efficiency of your tax department and in the effectiveness of staff members who participate in the preparation and review of tax returns.

Pencil Copy Returns for Clients Are Successful

This department has been a prime mover in advocating the reproduction of tax returns by photo or other mechanical methods. The idea received a good reception except for one seemingly insurmountable obstacle, namely, the mailing of pencil copy returns to clients. How would the clients react? Would the returns be legible? Would it constitute a lowering of standards?

Several firms, who prepare many hundreds of individual income tax returns annually, have, with some courage, sent out reproduced pencil copy

returns. They eagerly awaited clients reactions, and, strangely, very few were received, and none of a critical nature. One firm reported an unexpected incident, namely, that the client was so impressed by the possibilities of the reproduction method that he asked to see the machine at work. It is possible that some unfavorable impressions were not reported, but the accountants involved were obviously pleased with the results.

The problem of legibility of the returns was overcome by having men print the details. This alleviated the poor handwriting problem. It was found, however, that slightly more time was consumed in the preparation because greater care was exercised. This was offset, by an enormous margin, by the elimination of typing and proof-checking. A substantial economy was realized in typing costs. Equally important was the ability to get returns out earlier and more quickly; also, a very marked reduction in the physical and nervous strains in the typing department that generally prevail during the tax seasons. Another benefit was the ability to get out financial statements earlier, and without much pressure.

Unfortunately, New York State tax returns may not be reproduced. Efforts will be made, at a later date, to get the acquiescence of the State Tax Commission. When that is accomplished accountants will have fully eliminated one of the "terrors" of the profession.

Improving Staff Meetings

The use of a blackboard, or a similar device, can make some staff meetings far more effective than they could otherwise be. This is so because many

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people learn more rapidly by sight than by hearing. Moreover, illustrations are usually helpful for everyone.

Problems involving fine points of financial statement form, footnotes, methods and forms of disclosures, improved language, work paper form, adjusting entry explanations, and numerous other matters of common interest, can be dealt with more successfully if the oral discussion is supplemented by visual illustrations.

Space problems may rule out the use of a blackboard in a small or crowded office. However, there are available

folding easels (tripods) which permit the use of extra large size pads of paper. These gadgets will be found satisfactory in most cases. They are not too costly and when folded up require little space. They can be placed behind a door or cabinet, or in any inconspicuous spot.

A particular advantage of the paper board is that illustrations may be prepared in advance. Further, sheets that may be used again at a later date can be preserved. Firms that hold staff meetings and do not use visual aids would do well to give this matter consideration.



Payroll Tax Notes

(Continued from page 355)

ing from 40% or more down to less than 10%.

4. The "Age" factor, depending upon the number of years the employer has been liable for contributions under the law, may result in an employer picking up from .5 points, if his liability for contributions has been less than 5 years, to 2 points, if his coverage has extended over a period of 13 years or more.

Employers not otherwise eligible for reduced rates should explore the pos-

sibility of having joint accounts established in order to become qualified. The rules of the Industrial Commissioner in this regard should be strictly followed. In event of any business transfer in whole or in part, notice should be given to the Industrial Commissioner. Where an adverse experience rate resulted from continuing a joint account long after its usefulness had expired, it should be dissolved. Any party to the joint account may apply to the Commissioner for its dissolution.

OFFICIAL DECISIONS *and* RELEASES

Important Notice

Certified Public Accountancy

On March 27, 1953 the Regulations of the Commissioner of Education relating to certified public accountancy were amended. These amendments will affect the May, 1953 examination as well as future examinations. We are transmitting herewith a copy of the new Sections 91 and 92 of the regulations so that you may be fully informed as to their content. Furthermore we are including with the regulations this special notice which emphasizes certain of the more important features of the regulations and indicates how they will be interpreted.

Subjects of the Examination

Two groups of subjects have been established for the examination in certified public accountancy, as follows:

- Group 1—the subjects of theory of accounts and of commercial law
- Group 2—the subjects of practical accounting and of auditing.

Admission to Group 1 Subjects

Candidates shall be entitled to admission to the Group 1 subjects after they have graduated from college and completed the registered accountancy curriculum therein, or have graduated from college and have had equivalent college training in accountancy as determined by the commissioner of education.

Admission to Group 2 Subjects

Candidates shall be entitled to admission to the Group 2 subjects after they have passed Group 1 subjects and they have completed three years experience in the public practice of accountancy satisfactory to the State Board of Certified Public Accountant Examiners; or

Candidates with satisfactory experience may elect to be admitted to the Group 2 subjects *While They Are Sitting* for Group 1 subjects. They may not sit for Group 2 subjects *Only* unless they have passed both subjects of Group 1.

Sections 91 and 92 of the Regulations Mean:

a A candidate who has been declared eligible for admission to both subjects of Group 2 may postpone the taking of these subjects until after he has successfully com-

pleted both subjects of Group 1. He must, however, make the specific request to postpone the subjects of Group 2 when requesting the admission card for a particular examination. Furthermore, immediately upon receipt of the admission card he should check to see that his request has been observed. *All subjects must be taken in accordance with the admission card issued to the candidate, and an automatic failure will be assigned for all subjects for which he does not report.*

b Candidates approved for admission to all subjects, including practical accounting, under prior regulations may have already received passing grades in one of the Group 1 and one of the Group 2 subjects. Such candidates may also request permission to postpone the taking of the remaining Group 2 subject until such time as the Group 1 subject has been passed. Such request must also be made clearly to the Department before the admission cards are mailed.

c Any candidate who takes one or both of the Group 2 subjects without having previously passed the Group 1 subjects, or *without sitting* for the Group 1 subjects at the same examination, will *NOT* receive credit for either one or both of the Group 2 subjects taken at that examination, in which he may receive satisfactory ratings.

A candidate, for example, who appears for the Group 2 subjects on the first two days of the examination, as indicated on his admission card, and is for any reason unable to appear on the third day of the examination for the Group 1 subjects, will not receive credit for either subject of Group 2 in which he may receive a satisfactory rating.

d Candidates who do not receive satisfactory ratings in both subjects of Group 1 at any one sitting, must be *reexamined in both subjects*. Candidates who pass *either subject in Group 2*, in accordance with the regulations, need *NOT* be reexamined in that subject. Candidates who receive credit for 2 of the 4 subjects under prior regulations will not be required to be reexamined in such subjects. Candidates who have passed one or both of the remaining subjects between January 1, 1947 and January 1, 1953 will not be required to be reexamined in either or both of these remaining subjects.

Admission Fees

All fees for admission to the examinations in certified public accountancy accepted by the Department prior to March 27, 1953 will be handled pursuant to the statute and regulations in existence prior to that date.

Official Decisions and Releases

Applications postmarked after March 26, 1953 must be accompanied by the following fees:

a All new applications for first admission to any part of the examination must be accompanied by a fee of \$30.

b All requests for readmission in any subject or subjects, postmarked after March 26, 1953 must be accompanied by a fee of \$5.

Recommendation

It is strongly recommended that all candidates entering the examination in certified public accountancy study carefully the new provisions of Sections 91 and 92 in conjunction with this special notice. Careful observations of the new regulation will assure more effective handling of the application for certificate as certified public accountant.

April 13, 1953

Amendments to the Regulations of the Commissioner Adopted March 27, 1953

Sec. 91. Professional requirements. 1. The examination in certified public accountancy shall consist of

Group 1—the subjects of theory of accounts and of commercial law

Group 2—the subjects of practical accounting and of auditing.

Candidates for the certified public accountant certificate who have been graduated from a college offering a curriculum in accounting which shall have been registered by the Department or otherwise have complied with the education requirements of the Education Law shall be entitled to admission to the subjects of group 1 of the examination.

2. Candidates shall be entitled to admission to the group 2 subjects of the examination.

a. who have passed the subjects of group 1 or

b. while sitting for the subjects of group 1 and

c. who have completed three years experience in the intensive diversified application of accounting principles and in the intensive diversified application of auditing procedures in the public practice of accountancy satisfactory to the State Board of Certified Public Accountant Examiners, subject to review by the Commissioner of Education. The said experience shall be completed not less than 90 days prior to the date of the examination. The State Board of Certified Public Accountant Examiners shall accept service in the armed forces of the United States subsequent to July 1, 1940 on the basis of one month's credit for each six months' service with a maximum credit of eight months.

3. Candidates who fail either subject of

group 1 of the examination shall be re-examined in both subjects. Candidates who pass either subject in group 2 shall not be re-examined therein. Notwithstanding the foregoing, candidates who were admitted under previous regulations, and who have passed any two subjects of the four required subjects at any one sitting between January 1, 1947 and January 1, 1953, and subsequently pass the remaining subjects, shall not be re-examined in such subjects. Upon passing the subjects of both groups 1 and 2 and meeting all other requirements established by law and the regulations of the Commissioner, the candidate will be entitled to the certified public accountant certificate.

Sec. 92. Other requirements. 1. The certified public accountant examination shall be held at such times and places as shall be determined by the Commissioner.

2. * * * *

3. Each application for admission to the subjects of group 1 of the examination must be accompanied by a recent photograph approximately two by three inches in size and by a fee of \$30, which fee shall entitle the candidate to admission to one examination in the subjects of group 1 and to admission to one examination in the subjects of group 2. A fee of five dollars is required for each re-examination in any subject or subjects. Any candidate who has failed any subject in four successive examinations to which he has been admitted shall not be eligible for admission to any subject in the two succeeding examinations. Such ineligibility holds even if the candidate does not take consecutive examinations scheduled by the Department. Candidates are required to sit for all subjects indicated on their admission card. They will be assigned an automatic failure for all subjects for which they do not report.

4. * * * *

5. An application for admission to the subjects of group 1 shall be filed with the Department not less than 30 days prior to the date of the examination; an application for admission to the subjects of group 2 shall be filed with the Department not less than 90 days prior to the date of the examination. Any false or misleading information in connection with any application may be cause for exclusion from the examinations on the ground of lack of good moral character. If the Department finds that the application is complete and that all of the requirements have been met, it shall issue to the applicant an admission card which shall advise him of the time, date and place of the examination. When the candidate submits each examination paper he shall exhibit his admission card to the examiner. At the conclusion of the final examination the examiner shall retain the card.

6. * * * *

The New York Certified Public Accountant

THE UNIVERSITY OF THE STATE OF NEW YORK
The State Education Department
STATE BOARD OF
CERTIFIED PUBLIC ACCOUNTANT EXAMINERS

Three Years Experience Requirement

Notice to Candidates for the C.P.A. Examinations

The employment submitted by candidates applying for admission to the practical accounting and auditing examinations must satisfy the statute and regulations as stated below:

Article 149, Section 7401, paragraph 4 of the Education Law defines the public practice of accountancy as follows:

"The public practice of accountancy within the meaning of this article is defined as follows: A person engaged in the public practice of accountancy who, holding himself out to the public as an accountant, in consideration of compensation received or to be received by him, offers to perform or does perform, for other persons, services which involve the auditing or verification of financial transactions, books, accounts or records, or the preparation, verification or certification of financial, accounting or related statements intended for publication or for the purpose of obtaining credit, or who, holding himself out to the public as an accountant, renders professional services or assistance in or about any or all matters of principle or detail relating to accounting procedure or the recording, presentation or certification of financial facts or data."

Section 91, paragraph 2 of the Regulations of the Commissioner of Education reads as follows:

"Candidates who complete three years of diversified accounting experience satisfactory to the State Board of Certified Public Accountant Examiners, subject to review by the Commissioner of Education, shall be entitled to admission to the examination

in auditing and in practical accounting. Diversified accounting experience to be considered satisfactory shall be such as to have required the intensive application of accounting principles and auditing procedures in the public practice of accountancy. The State Board of Certified Public Accountant Examiners shall accept service in the armed forces of the United States subsequent to July 1, 1940, on the basis of one month's credit for each six months' service with a maximum credit of eight months. The three years required experience shall be completed not less than ninety days prior to the date of the examination."

Generally, experience satisfying the requirements is more readily obtained under the supervision of a practicing certified public accountant. However, experience earned in the employ of a noncertified public practitioner or firm of practicing public accountants or the practice of public accounting on the candidate's own account will be evaluated.

The experience presented by the candidate must satisfy the test of diversity in applying a variety of auditing procedures and techniques to the usual and customary financial transactions recorded in accounting records, and must be on a full-time basis. Assignments involving the writing up of books for clients or work of a clerical nature performed in the office of a public accounting firm, certified or noncertified, does not satisfactorily meet the requirement. The attestations of employers (and letters of clients, where the candidate is practicing on his own account) should include sufficient detail to determine the diversity of the candidate's experience in the intensive application of accounting principles and auditing procedures in the public practice of accountancy. It is upon the evaluation of the nature and quality of the experience and its sufficiency to meet the requirement that the determination is made by the board as to whether or not more than three years of such experience would be required. It is possible that the board could require up to six years of such experience.



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